

**EIGHTH IN A SERIES OF SUBCOMMITTEE  
HEARINGS ON PROTECTING AND  
STRENGTHENING SOCIAL SECURITY**

---

**HEARING**  
BEFORE THE  
SUBCOMMITTEE ON SOCIAL SECURITY  
COMMITTEE ON WAYS AND MEANS  
U.S. HOUSE OF REPRESENTATIVES  
ONE HUNDRED NINTH CONGRESS  
FIRST SESSION

\_\_\_\_\_  
JUNE 23, 2005  
\_\_\_\_\_

**Serial No. 109-27**

\_\_\_\_\_

Printed for the use of the Committee on Ways and Means



U.S. GOVERNMENT PRINTING OFFICE

26-386

WASHINGTON : 2006

---

For sale by the Superintendent of Documents, U.S. Government Printing Office  
Internet: [bookstore.gpo.gov](http://bookstore.gpo.gov) Phone: toll free (866) 512-1800; DC area (202) 512-1800  
Fax: (202) 512-2250 Mail: Stop SSOP, Washington, DC 20402-0001

## COMMITTEE ON WAYS AND MEANS

BILL THOMAS, California, *Chairman*

E. CLAY SHAW, JR., Florida	CHARLES B. RANGEL, New York
NANCY L. JOHNSON, Connecticut	FORTNEY PETE STARK, California
WALLY HERGER, California	SANDER M. LEVIN, Michigan
JIM MCCRERY, Louisiana	BENJAMIN L. CARDIN, Maryland
DAVE CAMP, Michigan	JIM MCDERMOTT, Washington
JIM RAMSTAD, Minnesota	JOHN LEWIS, Georgia
JIM NUSSLE, Iowa	RICHARD E. NEAL, Massachusetts
SAM JOHNSON, Texas	MICHAEL R. MCNULTY, New York
PHIL ENGLISH, Pennsylvania	WILLIAM J. JEFFERSON, Louisiana
J.D. HAYWORTH, Arizona	JOHN S. TANNER, Tennessee
JERRY WELLER, Illinois	XAVIER BECERRA, California
KENNY C. HULSHOF, Missouri	LLOYD DOGGETT, Texas
RON LEWIS, Kentucky	EARL POMEROY, North Dakota
MARK FOLEY, Florida	STEPHANIE TUBBS JONES, Ohio
KEVIN BRADY, Texas	MIKE THOMPSON, California
THOMAS M. REYNOLDS, New York	JOHN B. LARSON, Connecticut
PAUL RYAN, Wisconsin	RAHM EMANUEL, Illinois
ERIC CANTOR, Virginia	
JOHN LINDER, Georgia	
BOB BEAUPREZ, Colorado	
MELISSA A. HART, Pennsylvania	
CHRIS CHOCOLA, Indiana	
DEVIN NUNES, California	

ALLISON H. GILES, *Chief of Staff*  
JANICE MAYS, *Minority Chief Counsel*

---

## SUBCOMMITTEE ON SOCIAL SECURITY

JIM MCCRERY, Louisiana, *Chairman*

E. CLAY SHAW JR., Florida	SANDER M. LEVIN, Michigan
SAM JOHNSON, Texas	EARL POMEROY, North Dakota
J.D. HAYWORTH, Arizona	XAVIER BECERRA, California
KENNY C. HULSHOF, Missouri	STEPHANIE TUBBS JONES, Ohio
RON LEWIS, Kentucky	RICHARD E. NEAL, Massachusetts
KEVIN BRADY, Texas	
PAUL RYAN, Wisconsin	

Pursuant to clause 2(e)(4) of Rule XI of the Rules of the House, public hearing records of the Committee on Ways and Means are also published in electronic form. **The printed hearing record remains the official version.** Because electronic submissions are used to prepare both printed and electronic versions of the hearing record, the process of converting between various electronic formats may introduce unintentional errors or omissions. Such occurrences are inherent in the current publication process and should diminish as the process is further refined.

## CONTENTS

Advisory of June 16, 2005 announcing the hearing .....	2
--------------------------------------------------------	---

### WITNESSES

Social Security Administration, Hon. James B. Lockhart, Deputy Commissioner .....	5
U.S. government Accountability Office, Barbara D. Bovbjerg, Director, Education, Workforce, and Income Security .....	10

American Enterprise Institute, Alex J. Pollock .....	52
Congressional Research Service, Patrick J. Purcell .....	42
Federal Retirement Thrift Investment Board, Francis X. Cavanaugh .....	67
National Academy of Social Insurance, Virginia P. Reno .....	74
National Women's Law Center, Joan Entmacher .....	58
Wharton School, University of Pennsylvania, Olivia S. Mitchell, Ph.D. ....	35

### SUBMISSIONS FOR THE RECORD

Clark, Robert, North Carolina State University, Raleigh, NC, statement .....	89
Copeland, Craig, Employee Benefit Research Institute, statement .....	91
Cyr, Paul, Greene, ME, statement .....	93
Jones, Ike, America's Community Bankers, statement .....	94
Lancon, Renee, West Hills, CA, statement .....	96
Mitchell, Olivia, Wharton School, Univ. of Pennsylvania, Philadelphia, PA, statement .....	99
Sewell, Robin, Littleton, MA, statement .....	104



**EIGHTH IN A SERIES OF SUBCOMMITTEE  
HEARINGS ON PROTECTING AND  
STRENGTHENING SOCIAL SECURITY**

---

**THURSDAY, JUNE 23, 2005**

U.S. HOUSE OF REPRESENTATIVES,  
COMMITTEE ON WAYS AND MEANS,  
SUBCOMMITTEE ON SOCIAL SECURITY  
*Washington, DC.*

The Subcommittee met, pursuant to notice, at 10:00 a.m., in room B-318, Rayburn House Office Building, Hon. Jim McCrery (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

# ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

## SUBCOMMITTEE ON SOCIAL SECURITY

FOR IMMEDIATE RELEASE  
June 16, 2005  
No. SS-8

CONTACT: (202) 225-9263

### **McCrery Announces Eighth in a Series of Subcommittee Hearings on Protecting and Strengthening Social Security**

Congressman Jim McCrery (R-LA), Chairman, Subcommittee on Social Security of the Committee on Ways and Means, today announced that the Subcommittee will hold the eighth in a series of Subcommittee hearings on protecting and strengthening Social Security. **The hearing will examine options for the administration of personal retirement accounts. The hearing will take place on Thursday, June 23, 2005, in room B-318 Rayburn House Office Building, beginning at 10:00 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Subcommittee and for inclusion in the printed record of the hearing.

#### **BACKGROUND:**

The past two Administrations, the 1994-1996 Social Security Advisory Council, and the 2001 President's Commission to Strengthen Social Security, have laid out proposals to establish personal accounts that are either integrated with Social Security benefits or in addition to Social Security benefits. Personal accounts have been proposed as a means to enhance individuals' retirement income, as Social Security's Trustees have warned that current-law promised Social Security benefits cannot be paid in full in the future absent action to address the program's long-term insolvency.

An important aspect of the development of personal accounts involves system design, including account management and recordkeeping, investment options, and methods to pay benefits to workers at retirement. An equally important aspect is that administrative expenses must be kept low to preserve workers' account balances.

Numerous nonpartisan studies, including studies by the U.S. Government Accountability Office and the Social Security Administration, indicate that system design issues are of vital importance for the successful widespread use of personal retirement accounts. While the design possibilities are many and varied, the experience derived from the management of other large-scale retirement systems, such as the Federal Thrift Savings Plan, can provide valuable insights.

In announcing the hearing, Chairman McCrery stated, "As we consider how personal retirement accounts would strengthen retirement security, we must acknowledge that the proper design of a personal account system is not a mere technical detail. Rather, we must carefully consider key questions on implementation, administration, and public education to ensure workers receive the quality service they deserve, along with low expenses that preserve account balances."

### **FOCUS OF THE HEARING:**

The hearing will focus on options for designing a system of personal retirement accounts to ensure that the accounts are managed efficiently and accurately, with low administrative fees to preserve account balances. Options for paying out account balances at retirement will also be examined.

### **DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:**

**Please Note:** Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, <http://waysandmeans.house.gov>, select “109th Congress” from the menu entitled, “Hearing Archives” (<http://waysandmeans.house.gov/Hearings.asp?congress=17>). Select the hearing for which you would like to submit, and click on the link entitled, “Click here to provide a submission for the record.” Once you have followed the on-line instructions, completing all informational forms and clicking “submit” on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You **MUST REPLY** to the email and **ATTACH** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business Thursday, July 7, 2005. **Finally**, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225-1721.

### **FORMATTING REQUIREMENTS:**

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone and fax numbers of each witness.

**Note:** All Committee advisories and news releases are available on the World Wide Web at <http://waysandmeans.house.gov>.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202-225-1721 or 202-226-3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

---

Chairman MCCRERY. The hearing will come to order. Good morning. Welcome, everyone, to our eighth Subcommittee hearing on protecting and strengthening Social Security. Today, we will look at system design issues for personal accounts, including ac-

count management and recordkeeping, annuities, administrative fees, and issues related to converting account balances into a monthly income. Yesterday, I and several of my colleagues here on the Subcommittee, Mr. Shaw, Mr. Johnson, and Mr. Ryan, took the first step on stopping the raid on Social Security. Our Chairman, Bill Thomas, called this a common sense approach, and I think the American people would agree. It is simple common sense that the Social Security surplus needs to be preserved for retirement income, and H.R. 3304, the "Growing Real Ownership for Workers (GROW) Accounts Act," will do just that.

The GROW accounts would be fully inheritable, voluntary, and initially invested in safe, marketable Treasury bonds. Naturally, the success of any type of personal account system involves the careful consideration of system design issues. America's workers and their families deserve a voluntary personal account system that will give them excellent service, offer prudent and diversified investment options, protect their investments with good stewardship, and preserve their account balances through low administrative fees. I welcome our distinguished panels today, and I look forward to hearing your views. Mr. Levin?

Mr. LEVIN. Thank you, Mr. Chairman. I am glad this hearing has been called so we can delve into issues like offsets and clawbacks, so that we can understand fully the administrative complexities, and some of the testimony will very much focus on that, and I think bring out some complexities that aren't understood. We will also have a discussion of administrative costs, and we need to do that. Indeed, the timing of this hearing could not be more salient because of the developments in the last 24 hours. It is very clear, if it wasn't before, that privatization of Social Security is basically what this argument is all about.

The proposals of the last 24 hours make it very clear that privatization is at the heart of the Republican approach, the replacement of Social Security with private accounts, but privatization at any cost. What has been suggested in recent hours, we would continue the use of Federal Insurance Contributions Act (FICA) taxes other than for Social Security, one way or another, solvency would be made worse. The fiscal irresponsibility of this Congress and this President could continue because Social Security funds could continue to be used for other purposes, and uncertainty would really increase for everyone. Instead of a guaranteed benefit in a Social Security system for people who are retired or who are going to retire, for people who become disabled, for survivors. Instead of the certainty of a guaranteed benefit, we would end up with uncertainty for everybody, for those who would be in the Social Security system and for those who would have these private accounts. So, I think it is useful now to delve into these issues of what private accounts would mean in terms of complexity, in terms of cost, in terms of offsets. So, let's get with it.

Chairman MCCRERY. Thank you, Mr. Levin. Our first panel this morning is a familiar one to us on the Committee on Ways and Means, the Honorable James B. Lockhart, Deputy Commissioner of the Social Security Administration (SSA) and Ms. Barbara Bobbjerg, Director of Education, Workforce and Income Security with the U.S. government Accountability Office (GAO). Welcome



back, it is nice to have you. We welcome your testimony this morning. Your entire written testimony will be included in the record. If you could summarize that in about five minutes each, we would appreciate it. Mr. Lockhart.

**STATEMENT OF THE HONORABLE JAMES B. LOCKHART,  
DEPUTY COMMISSIONER, SOCIAL SECURITY ADMINISTRATION**

Mr. LOCKHART. Thank you, Chairman McCrery, and Members of the Subcommittee. Thank you for holding this series of hearings on protecting and strengthening Social Security, and for inviting me to discuss the administration of voluntary personal accounts. The idea of creating a system of personal accounts as part of reforming Social Security has received much attention, including proposals developed by President Clinton and President Bush's Social Security Commissions. There are a number of models for administering a system of personal accounts. The most recent personal accounts proposals envision a voluntary program with a centrally administered system modeled on the Thrift Savings Plan (TSP), and Social Security's existing annual wage reporting system. This is not a decentralized small business 401(k) model.

Assuming a centralized approach, Social Security independent actuaries estimate an ultimate cost of 30 basis points of assets under management for personal accounts. This cost seems reasonable, and in my opinion, may fall as the amount of assets under management grows. There will be significant challenges, but I believe that over a reasonable implementation period of perhaps 3 years, we could produce an efficient, equitable, and accurate system of personal retirement accounts. Social Security personal accounts could quickly achieve very large economies of scale. Under the President's personal accounts framework, there would be 120 million personal accounts, with assets totaling \$602 billion by the end of 2015. As a centralized system of personal accounts is developed, its business processes should reflect a coherent set of underlying designed principles.

As I detail in my written testimony, there are seven basic processes: Education, Enrollment, Contribution, Investment, Record-keeping, Compliance, and Payout. There are proven, low-cost models for each of these processes. Many proposals suggest creating a new government agency with an independent board similar to the TSP that would have primary responsibility for administering the plan, with strong support from the SSA.

The TSP is a very good, low-cost model for personal accounts. It has 3.4 million participants, and \$157 billion of assets under management. It offers five investment alternatives, including a Treasury bond option, and four very low-cost index funds which are designed to replicate the returns of broad, corporate bond and stock market indexes. It is also adding a life cycle fund this summer. The TSP's costs are six basis points, and the investment manager receives very, very little of that. Some people have suggested that the TSP is not an appropriate model because there are about six-and-a-half million employers in the United States, while there are only about 130 government agencies providing payroll information to the TSP. While this is true, I believe our proven and low-cost wage reporting process could provide a single interface between employ-

ers and self-employed individuals and the program's central record keeper.

Social Security processes 240 million W-2s annually for approximately 149 million workers. Over the last 6 years, electronic filing has grown from just 7 percent to 65 percent. In 3 years, we are targeting to hit 82 percent. Social Security already makes software available that allows small employers to report electronically. Social Security receives W-2s beginning in January for the previous year. Due to the lag in reporting, some plans suggest there could be a holding fund, where the contributions would be deposited until individual accounts could be credited, with not only the amount taken out from payroll taxes, but also the interest on that amount.

A strengthened Social Security program that includes personal accounts that provide individual Americans with ownership and more personal control over their retirement income is feasible. Using the model of the TSP, along with systems already in place, costs could be minimized. As the assets grow, more choices and flexibilities could be added at a reasonable cost. As President Bush said in his State of the Union Address, and I quote, "The goal here is greater security in retirement, so, we will set careful guidelines for personal accounts." Commissioner Barnhart and I are committed to strengthening and protecting Social Security, and to making sure the SSA is ready to assist the Administration and Congress in doing so. As the Social Security trustees, President Bush, and many others have said, we need to take action soon to save Social Security for future generations. Thank you, and I will be happy to address any questions.

[The prepared statement of Mr. Lockhart follows:]

**Statement of The Honorable James B. Lockhart, Deputy Commissioner,  
Social Security Administration**

I would like to thank Chairman McCrery and the Members of the Subcommittee for holding this series of hearings on protecting and strengthening Social Security and for inviting me to discuss the administration of voluntary personal retirement accounts.

My remarks today are based on the work that has been done by many groups as well as over 30 years of off and on personal experience with corporate pensions. My experiences range from serving on the pension committee of one of the largest corporations in the country, to starting a 401(k) plan for a small business, to serving as the Executive Director of the Pension Benefit Guaranty Corporation.

Over the past decade, the idea of creating a system of personal accounts as part of reforming Social Security has received much attention, including proposals developed by the 1994-96 Social Security Advisory Council and the 2001 President's Commission to Strengthen Social Security. As a result, SSA has looked at the issues involved in administering such a program. We have also studied the Federal Thrift Savings Plan (TSP) and met with their staff and their systems contractor to discuss pertinent issues and draw on their experience. I have also seen SSA successfully implement other large projects such as our new electronic disability system and the rollout of the new application for extra help with prescription drug costs under Part D of Medicare.

A number of models for administering a system of personal accounts have been discussed. Over the last several years, most personal account proposals envision a voluntary program with a centrally administered system modeled on the TSP.

Assuming this approach, Social Security's independent actuaries reduce their estimate of real investment returns of 4.9% by an ultimate annual cost of 0.3% (30 basis points) of assets under management for personal accounts. A basis point is 1/100th of one percent, so 30 basis points would equal \$3 per \$1,000 of assets. This cost seems reasonable and, in my opinion, may fall as the system matures and gets larger.

There would be significant challenges, but I believe that over a reasonable implementation period of perhaps three years, we could produce an efficient, equitable, and accurate system of personal retirement accounts.

I want to note that I have not been talking about a small business corporate 401(k) plan model, which some critics of personal accounts do. 401(k) plans are expensive for small businesses to administer because of their small scale and because of the regulatory burden. Nor am I using a large employer 401(k) model that has lots of choices, although some do have annual fees less than 30 basis points. To the contrary, I am focusing on a centralized model using the Social Security Administration's existing annual wage reporting (Form W-2) system and the proven TSP model. I believe that this approach is the key to successful and timely implementation of a personal account system.

Social Security personal accounts could quickly become the largest defined contribution plan in the world and achieve very large economies of scale. Assuming a two-thirds participation rate, the Social Security actuaries project that under the President's personal account framework, which phases in personal accounts from 2009 to 2011, there would be about 120 million personal accounts with assets totaling \$602 billion (in constant 2004 dollars) at the end of 2015.

As a centralized system of personal accounts is developed, its business processes should reflect a coherent set of underlying design principles. The goal should be to enable the pieces of the new system to fit together in a seamless manner, keep administrative costs to a minimum, speed implementation, and boost public acceptance. There are 7 basic processes in a personal account system, which are:

- **Education**—The process of providing plan information at various points in time and to distinct categories of individuals, enabling them to make informed decisions.

Initially, the general public would need to be educated about the plan's structure, operation, and participation benefits so that workers could decide whether or not to enroll. Subsequently, those who enroll would need more detailed information about investment opportunities and the status of their accounts. Finally, those about to retire and beneficiaries of deceased participants would need information that outlines options available for accessing account assets.

- In addition to the initial, one-time education of the general public about the account plan, a continuous educational program would need to be in place for the over 4 million new workers a year who would need to make an enrollment decision.
- **Enrollment**—The process of obtaining a worker's consent and supporting information to create a personal account. The supporting information includes the person's identifying information, investment fund selections, beneficiary data, and contact information.

A plan could enroll workers via the Internet and machine readable paper forms. Enrollment could be done by "opting-in" or "opting-out". The latter means that a worker would have to fill out a form stating that he or she did not want to volunteer for personal accounts. In the corporate 401(k) world, opting-out has successfully raised enrollment rates. No matter which enrollment option was chosen, the administrator would likely need to mail out confirming "welcome" packages to enrollees that acknowledge receipt of the applications and provide more detailed educational materials about the plan.

This process entails a large, initial start-up process to establish accounts for current workers and then a continuing process to create accounts for new workers.

- **Contribution**—The process of collecting, verifying, and crediting wage information and money from approximately 6.5 million employers and 15 million self-employed workers.

The most efficient method for collecting the contributions would be through the current payroll deduction process, as it would demand the least change for employers. However, other options exist that would entail more frequent employer reporting, electronic reporting, direct employer reporting to the account administrator, or use of other reporting/collection avenues, such as the State workforce agencies.

- **Investment**—The process of quickly and accurately investing contributions in funds chosen by the participants.

This process involves setting the plan's investment policies, establishing available funds for participant investment, selecting investment managers, making timely fund purchases, and updating account balances based on fund performance.

- *Recordkeeping*—The process of maintaining account information and providing service to participants.

The process would need to provide participants with periodic account statements and the ability to update account records as personal situations change; for example, as addresses, marital status, or beneficiary selections change. It would also need to allow participants to modify how their contributions are invested and to reallocate their assets between funds.

In addition, the plan would need to provide the means to answer account or plan-related questions from participants, beneficiaries, employers, and the general public. This would entail a large internet/website operation as well as a large teleservice component.

- *Compliance*—The process for monitoring the program to ensure that workers, employers, beneficiaries, and fiduciaries comply with statutes and regulations.

A plan would need to develop procedures to monitor transactions and audit financial records, and make corrections to account records where errors are detected. In addition, the plan would need to have an appellate process that could hear worker or employer requests for reconsideration of the corrective actions.

- *Payout*—The process for dispersing account assets to participants during retirement or to beneficiaries of workers who die prior to retirement.

Many proposals envision that workers would annuitize to remain above a poverty level-related threshold. Options for releasing the remaining assets above the threshold include paying them out as lump sums or as phased withdrawals.

Included in this process would be making various types of annuities available to retirees and their spouses, and possibly the administration of the entire annuitization program. Moreover, the process would need to have procedures in place to locate beneficiaries and deal with abandoned accounts.

There are proven, low cost models for each of these processes. As others point out, there are also proven, expensive models. In designing a personal account system, Congress should take care to choose options that follow the low cost model. Over time, more flexibility and options could be added as needed.

Many proposals suggest a new independent government agency with an independent board similar to the TSP that would have primary responsibility for most of these activities, with the strong support of the Social Security Administration. In particular, SSA could play a key role in the front-end education, enrollment and contribution phases and potentially in the payout phase. The education process in particular could involve many government agencies building on the Financial Literacy and Education Council as well as business and not-for-profits ongoing financial education efforts.

The TSP is a very good, low cost role model for personal accounts. It has 3.4 million participants and \$157 billion of assets under management. It offers 5 investment alternatives including a Treasury bond option and four very low cost indexed funds, which are invested to replicate the returns of broad market indexes. These four TSP funds are very comprehensive and include a corporate bond fund, a Standard and Poor's 500 fund, a U.S. smaller companies fund covering U.S. stocks not in the S&P 500, and an international equity fund.

In addition, by September 2005, TSP plans to add lifecycle funds using a combination of investments in each of the 5 funds in their system. These lifecycle funds gradually and automatically move assets into less volatile investments as the participant gets closer to retirement. For instance, the TSP lifecycle fund for younger workers will have 85 percent invested in equities and by retirement age the equity percentage would be reduced to 20 percent. The idea, which President Bush has endorsed, is to lessen investment volatility as one reaches retirement age. Life cycle funds are especially appealing to persons who do not wish to make a fund selection or actively manage their accounts. At payout or retirement, TSP offers lump sums, monthly payouts, or annuities.

The TSP does all of that with only 90 people plus approximately 400 contract employees and a net cost of \$95 million in FY 2005, or 6 basis points of the assets under management. Almost all of this cost is administrative fees. The fees of Barclays Global Investors, the TSP investment managers, represent a very small portion of those 6 basis points.

The TSP recordkeeping system would be an excellent model for the administration of personal accounts even though it has more capabilities than would be needed initially for a Social Security personal account system. TSP and its contractor have told us that their computer system could be adapted to Social Security personal accounts.

Some people have suggested that the TSP is not an appropriate model because there are about 6.5 million employers in the United States while there are only about 130 government agencies providing payroll information to the TSP. While this is true, I believe the existing SSA wage reporting process could provide a similar single interface between eligible employees and self-employed individuals and the program's central record keeper.

Using the existing wage reporting system would provide a low cost and efficient way to collect contribution information. Social Security processes 240 million W-2s annually for approximately 149 million workers. We have a major push under way to increase electronic filing. Over the last six years, electronic filing has grown from 7 percent to 65 percent and we are targeting 82 percent by 2008, and 95 percent by 2012. By law, employers with over 250 employees must report electronically.

Social Security begins receiving W-2s in January for the previous year. We begin processing immediately with 82 percent processed by April 30th and 99 percent by September. Because of the lag in reporting, the President's Commission on Strengthening Social Security suggested that there could be a "holding" fund where contributions would be deposited until individual accounts could be reconciled. This reconciliation would occur once the individual's W-2 information was processed and the personal account would receive the amount contributed plus interest.

As you look at the design of a personal account system, you may want to consider basic principles that would facilitate a simple, efficient process that minimizes administrative burdens and participant costs. These include:

- *Utilize existing and proven processes.* As previously discussed, the TSP and Social Security's annual wage reporting system provide an excellent foundation for a timely, low cost and effective implementation of a Social Security personal account program.
- *Minimize worker and employer burden.* The public would most likely prefer a system that causes little additional work for workers and employers. Significant reporting responsibilities for employers could raise business costs, and may adversely impact employment.
- *Minimize the use of paper processes.* Building a new system would allow the unique opportunity to develop processes based on new and innovative methods where cost-effective processes do not already exist. Developing electronic-based means for collecting, storing, and releasing information would be consistent with e-Government concepts, could potentially reduce administrative costs, speed processes, and allow smoother interface with other administrative systems.
- *Limit investor-initiated changes.* Limiting investors initially to a few investment allocation changes per year would reduce administrative costs.
- *Limit account reporting.* Providing investors with quarterly account statements would help to keep reporting costs low and investor inquiries to a minimum. Reducing investor non-electronic inquiries about account statements would also help to reduce investor support costs.
- *Prevent pre-retirement account access.* By preventing access to accounts before retirement, administrative costs could be kept to a minimum, the process would be simpler, and the governing rules would be more understandable to participants.
- *Limit distributional alternatives.* Unlike the TSP, which has multiple annuity and payout options, the personal account program should limit distributional options in order to minimize administrative costs. As the first retirees under a personal account plan would retire 10 years from enactment, there would be the opportunity to develop low cost, flexible payout alternatives.

In conclusion, while specific issues and costs related to the administration of personal accounts would vary with the specifics of the plan, a strengthened Social Security program that includes personal accounts that provide individual Americans with ownership and more personal control over their retirement income is feasible. Using the model of the Federal TSP along with systems already in place, costs could be kept to an acceptable minimum. And as the assets under management and account sizes grow, allowing additional economies of scale, more choices and flexibilities can be added at a reasonable cost.

As President Bush said in his 2005 state of the Union Address, "The goal here is greater security in retirement, so we will set careful guidelines for personal account." He also said, "We'll make sure there are good options to protect your investments—" That is very doable and I would add that a properly designed personal account plan could ensure a better deal for younger workers.

Commissioner Barnhart and I are committed to strengthening and protecting Social Security and to making sure that SSA is ready to assist the Administration and

Congress in doing so. Given sufficient time and resources, SSA could successfully implement and administer our share of a personal account program. I will be happy to address any questions you may have.

---

Chairman MCCRERY. Thank you, Mr. Lockhart. Ms. Bovbjerg.

**STATEMENT OF BARBARA D. BOVBJERG, DIRECTOR, EDUCATION, WORKFORCE AND INCOME SECURITY, U.S. GOVERNMENT ACCOUNTABILITY OFFICE**

Ms. BOVBJERG. Thank you, Mr. Chairman, Members of the Subcommittee. Thank you for continuing to invite me to discuss Social Security reform issues before you; I really appreciate it. Today, you have asked me to address issues of individual account design. There are many options and issues to consider when designing a system of individual accounts, and the choices that we make could affect not only participation in the accounts, but also, the benefits that might ultimately be received. I would like to structure my comments today around the three phases associated with retirement savings vehicles generally: The contribution phase, the accumulation phase, and the distribution phase. My remarks are drawn from a body of work that we have done, much of it for this Subcommittee, over the last several years. Let me begin with the contribution phase.

Determining how contributions to an individual account will be made involves choices as to size, whether the account is a substitute or a supplement, and whether participation should be voluntary or mandatory. Deciding whether accounts should be voluntary or mandatory is one of the most important design considerations. While offering the choice of whether to participate may be desirable, voluntary accounts require additional design considerations that mandatory accounts do not. For example, voluntary accounts likely will require incentives to induce participation, and these can be substantial as well as difficult to estimate accurately. Administration can be more complex for voluntary accounts, especially if participants are permitted to opt in and out of the accounts periodically. Although any changes to Social Security, any changes at all, must be well explained to the public, voluntary accounts make public education campaigns even more important.

Let me turn now to the accumulation phase. Critical decisions will be needed as to what investment choices will be offered and how the funds will be managed. A wide range of investment choices would offer individuals the ability to customize their investments to their own financial needs and preferences, but raises the risks that individuals could invest unwisely, and find accounts insufficient to finance their retirement. Wider choices also mean higher administration costs. Limiting investment choice would help to minimize risk, of course, but would limit the possible returns. Similarly, a centrally managed system would take advantage of economies of scale, as Mr. Lockhart mentioned, while a more decentralized approach would be more flexible, but also more costly. Essentially, the challenge is finding the right balance between individual choice, and risks and costs to the individual and to the government.

The last piece I will discuss is the distribution phase. Individual accounts could use three basic ways to pay retirement benefits: annuitization, timed withdrawals, and lump sum payments. Individuals could be allowed to choose from the three approaches, but offering such a range of choice could risk individuals outliving their retirement resources, and would represent relatively high administrative costs. Alternatively, mandatory annuitization could help ensure retirement income for the participants' lifetimes and would minimize adverse selection, which, in turn, would keep annuity prices lower, but would retain control over payouts from the individual.

Most importantly, policy makers must also consider whether to allow participants to borrow against their accounts at relatively low interest rates, as is permitted with 401(k) plans. Our work has shown that this option is important to inducing participation in voluntary savings plans, but results in lower account balances at retirement. While having access to one's own savings may likely be considered a basic aspect of account ownership, this consideration would have to be balanced against the potential diminution of retirement income that such a policy would risk. In conclusion, the wide range of possible options complicates the design of an individual account system. Our work shows that providing flexibility and choice generally increases system costs and complexity, and these will be important tradeoffs to consider if Social Security reform includes such restructuring.

Although bigger picture policy concerns necessarily dominate the Social Security debate at this stage, if individual accounts are to be features of the reformed program, design and administrative specifics much be addressed well in advance to changes of the law. This is not only for ease of implementation, but also to assure that time is allotted for the necessary public education. Even if an existing account structure, such as the TSP, were to be used for Social Security, the sheer number and diversity of Social Security participants and employers would complicate implementation and would require careful planning. That concludes my statement, Mr. Chairman. I am happy to answer any questions.

[The prepared statement of Ms. Bovbjerg follows:]

**Statement of Barbara Bovbjerg, Director of Education, Workforce, and Income Security, U.S. Government Accountability Office**

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss options for designing a system of individual accounts within the Social Security program. Social Security forms the foundation for our retirement income system and, in so doing, provides critical benefits to millions of Americans. However, the Social Security program is facing significant future financial challenges as a result of profound demographic changes. A wide variety of proposals to reform the program are currently being discussed, including restructuring the program to incorporate individual accounts. When designing a system with individual accounts, there are many options and issues to consider, such as whether the accounts should be voluntary or mandatory, the amount of choice individuals have over their investments, and how and when the funds are withdrawn from the accounts. The choices that have to be made will affect not only participation in the accounts, but also the amount of savings accumulated in the accounts and the benefit received from the account.

Today I will discuss options for the design of individual accounts specifically corresponding to the phases of a pension or similar retirement savings vehicle: the contribution phase, the accumulation phase, and the distribution phase. GAO has con-

ducted several studies related to the design, implementation, and administration of individual accounts. My statement is largely based on that work.<sup>1</sup>

In summary, the creation of an individual account system faces key design decisions in each of the phases that comprise the dynamics of a retirement savings vehicle. For example, regarding contributions, the size of the contribution and whether the accounts will be mandatory or voluntary must be decided. This decision will be shaped to some degree by the implicit relationship of the accounts to the current Social Security program. In the accumulation phase, individual account design must negotiate a number of trade-offs in setting, for example, the amount of choice in investment options and the level of customer service provided. Finally, individual accounts, like current defined contribution (DC) plans and individual retirement accounts (IRAs), must distribute accumulated account balances to individuals. A system of individual accounts covering over 156 million workers would constitute a fundamental change to Social Security and would be significantly larger than any existing retirement investment program. Affected individuals need to know about and understand the features of such a new system to make informed life decisions about work, savings, and retirement.

## BACKGROUND

According to the Social Security Trustees' 2005 intermediate, or best-estimate, assumptions, Social Security's cash surplus begins to decline in 2009, and in 2017 cash flow is expected to turn negative. In addition, all of the accumulated Treasury obligations held by the trust funds are expected to be exhausted by 2041. Social Security's long-term financing shortfall stems primarily from the fact that people are living longer and having fewer children. As a result, the number of workers paying into the system for each beneficiary has been falling and is projected to decline from 3.3 today to about 2 by 2040.

A common feature of many Social Security reform proposals is the creation of a system of individual accounts. Individual accounts would generally not by themselves achieve solvency for the Social Security system. Achieving solvency requires more revenue, lower benefits, or both. Many proposals that incorporate a system of individual accounts into the current program would reduce benefits under the current system and make up for those reductions to some degree with income from the individual accounts. Individual accounts also try to increase revenues, in effect, by providing the potential for higher rates of return on account investments than the trust funds would earn under the current system, but this exposes workers to a greater degree of risk.

Three key distinctions help to identify the differences between Social Security's current structure and one that would create individual accounts.

**Insurance versus savings.** Social Security is a form of insurance, while individual accounts would be a form of savings. As social insurance, Social Security protects workers and their dependents against a variety of risks such as the inability to earn income due to death, disability, or old age. In contrast, a savings account provides income only from individuals' contributions and any interest on them; in effect, individuals insure themselves under a savings approach.

**Defined benefit.** Social Security provides a defined benefit (DB) pension while individual accounts would provide a defined contribution (DC) pension. Defined benefit pensions typically determine benefit amounts using a formula that takes into account individuals' earnings and years of earnings. The provider assumes the financial and insurance risk associated with funding those promised benefit levels. Defined contribution pensions, such as 401(k) plans, determine benefit amounts based on the contributions made to the accounts and any earnings on those contributions. As a result, the individual bears the financial and insurance risks under a defined contribution plan until retirement.<sup>2</sup>

**Pay-as-you-go versus full funding.** Social Security is financed largely on a pay-as-you-go basis, while individual accounts would be fully funded. In a pay-as-you-go system, contributions that workers make in a given year fund the payments to beneficiaries in that same year, and the system's trust funds are kept to a relatively small contingency reserve.<sup>3</sup> In contrast, in a fully funded system, contributions for

<sup>1</sup> See the list of related GAO products at the end of this statement.

<sup>2</sup> At retirement, individuals have the option of purchasing an annuity with their defined contribution accounts, which then transfers the financial and insurance risk to the annuity provider. Before retirement, individuals may also have the option of purchasing deferred annuities.

<sup>3</sup> Social Security is now temporarily deviating from pure pay-as-you-go financing by building up substantial trust fund reserves. Social Security is collecting more in revenues than it pays in benefits each year partly because the baby boom generation makes the size of the workforce larger relative to the beneficiary population. In 2017, shortly after the baby boomers start to retire, the benefit payments are expected to exceed revenues, and the trust fund reserves and



a given year are put aside to pay for future benefits. The investment earnings on these funds contribute considerable revenues and reduce the size of contributions that would otherwise be required to pay for the benefits. Defined contribution pensions and individual retirement savings accounts are fully funded by definition. Both mandatory and voluntary individual account plans would reflect all of these distinctions.

In addition to these key distinctions, options for the design of individual accounts can be grouped in three categories corresponding to the different phases of a retirement savings vehicle:

- contribution phase: who should contribute, how much, and with what funds;
- accumulation phase: how are funds invested to make them grow; and
- distribution phase: how much of a benefit is received, when is it received, and in what form is it received.

As we have reported previously with respect to Social Security reform as a whole, as policy makers decide whether and how to create a system of individual accounts, they must balance a range of difficult concerns. These concerns include broad macroeconomic issues, such as how to finance the accounts and how the accounts would affect the economy and program solvency, as well as program benefit issues, such as how to balance opportunities for improved individual investment returns with the need to maintain an adequate income for those who rely on Social Security the most. No less important is the need to consider how readily individual accounts could be implemented, administered, and explained to the public. An essential challenge would be to help people understand the relationship between their individual accounts and traditional Social Security benefits, thereby avoiding any gap in expectations about current or future benefits. Individuals would also need to be informed enough to make prudent investment decisions, which would require investor education, especially if individual accounts were mandatory. This would be especially important for individuals who are unfamiliar with making investment choices.

#### **DESIGN CONSIDERATIONS IN THE CONTRIBUTION PHASE**

Determining how contributions to an individual account will be made requires choices about the role these contributions play vis-à-vis the current Social Security system. These choices include determining the size and role of contributions, management of contributions, whether the account is a substitute or a supplement, and whether participation in the accounts should be voluntary or mandatory.

##### **Size and Role of Contributions**

An individual account plan can provide for contributions in a variety of ways. For example, a plan might set contributions at a fixed rate, such as 2 percent of pay, or allow a range of rates with, possibly, a certain dollar limit. Some proposals provide for greater average contribution rates for lower earners than for higher earners. Individual accounts could be designed to include some progressive features, which could mirror the redistributive effects of the current Social Security program. For example, contribution rates may go down gradually as earnings rise, or alternatively, all workers might pay a fixed percentage but have a dollar cap on contribution amounts.

Ultimately the size of the individual account contribution rate determines the relative role of the DC aspect of the account versus the DB portion of the Social Security program. As a result, depending on their design, individual accounts will have a varying effect on the adequacy of benefits for certain subgroups of beneficiaries. For instance, disabled beneficiaries leave the workforce sooner than retired workers. With fewer years to make contributions (and accrue interest), disabled beneficiaries will likely have smaller account balances. At the same time, reform provisions that disfavor subgroups of earners can be offset by other provisions that favor them. As a result, any evaluations of reform proposals should not focus solely on individual account proposals but should consider both the DC and DB aspect of a proposal's provisions as a whole.

##### **Management of Contributions**

In managing individual accounts, contributions might be collected and deposited by the government in a centralized process or by employers or account providers in a decentralized process. Under a centralized process, which would build on the current payroll reporting and tax collection system, a federal agency, such as the Social

---

the interest they earn will help pay the baby boomers' retirement benefits. For more detail about this temporary trust fund buildup and how it interacts with the federal budget, see GAO, *Social Security Reform: Demographic Trends Underlie Long-Term Financing Shortage*, GAO/T-HEHS-98-43 (Washington, D.C.: Nov. 20, 1997).

Security Administration, would assume record-keeping responsibilities. Alternatively, a new centralized government clearinghouse could assume responsibility for centralized record keeping, similar to the structure for the federal Thrift Savings Plan. A decentralized structure could build on the system that has grown up around employer-sponsored 401(k) plans or individually managed IRAs. Under 401(k) plans, individual records are maintained by either the employer or a separate entity hired to manage the plan, or both. Under an IRA, the record-keeping responsibility rests with the individual investor and the financial institution where the funds are invested.

### **Substitute versus Supplementary Contributions**

Individual accounts can either supplement current Social Security contributions or substitute for all or part of them. With supplemental accounts, sometimes referred to as add-ons, the individual account and contributions to it have no effect on existing Social Security benefits. The supplemental account approach effectively leaves the entire current 12.4 percent payroll tax contribution available to finance the program while dedicating additional revenues for individual accounts. With substitute accounts, or carve-outs, the existing Social Security benefit is reduced (or offset) in some way to account for contributions that have been diverted from the program.<sup>4</sup> The obvious effect is that less revenue is available to finance the current benefit structure, which creates a problem of transition costs. Absent any other reforms, these transition costs increase in proportion to the individual account contribution rate. This means that either benefits must be reduced or additional resources must be devoted to the defined benefit portion of the Social Security program in the near term. The trade-off to incurring transition costs is that the expected higher rate of return on the individual accounts may permit somewhat higher benefits to be paid, although with increased risk.

### **Voluntary Contributions Require Additional Considerations**

Another important design feature to consider with respect to the contribution phase is whether the individual account is voluntary or mandatory. As we have previously reported, voluntary individual accounts require additional design considerations that mandatory accounts do not.<sup>5</sup> For instance a voluntary account could offer participants the ability to opt in and opt out of the account periodically; most U.S. proposals for voluntary accounts have not explicitly considered whether people would face a onetime or a periodic decision to participate. Individuals may consider the extent of such flexibility in deciding whether to participate in the accounts. Moreover, the need to track individuals' participation decisions requires additional administrative tasks and complexity. Educational efforts would be needed to inform individuals if their participation in an individual account would be advantageous or not, especially if the account substitutes for existing Social Security benefits.

Voluntary individual account plans may also require incentives to induce participation, while mandatory plans do not. In addition to increasing participation, incentives generally add to the value of the accounts and, therefore, ultimately to retirement income. Government contributions and tax advantages are just a few of the potential incentives for voluntary individual accounts. The costs of incentives can be difficult to estimate and can be substantial. Further, in certain circumstances, the net effect of voluntary individual account incentives may not result in improving overall retirement income. For example, if the voluntary account was also supplementary, then it might be difficult to determine whether a voluntary account adds to total retirement income, as it might merely substitute for other forms of saving. On the other hand, if the individual accounts truly add to total retirement income, they allow workers the opportunity and choice to build up additional savings to meet both income and health care cost needs in retirement.

Voluntary individual account plans can also affect the total system costs to the government, providers, employers, or participants, depending on design. In some

<sup>4</sup>In GAO's work to date, we have used the term "add-on" accounts to refer to accounts that would have no effect on Social Security benefits, would supplement those benefits, and would draw contributions from new revenue streams. In contrast, we have used the term "carve-out" accounts to refer to accounts that would result in some reduction or offset to Social Security benefits because contributions to those accounts would draw on existing Social Security revenues. Others have used these terms in different manners. For example, some have used "add-ons" in connection with new individual accounts funded from new revenue sources that result in a reduction or offset to some or all Social Security benefits. In the final analysis, there are two key dimensions: first, whether individual accounts are funded from existing or new revenue sources; second, whether individual accounts result in some reduction or offset to Social Security benefits.

<sup>5</sup>See GAO, *Social Security Reform: Information on Using a Voluntary Approach to Individual Accounts*, GAO-03-309, (Washington, D.C.: March 10, 2003).

cases, offering choice involves additional administrative, incentive, and educational costs. In particular, tracking individuals' participation decisions would require administrative processes that do not arise in mandatory plans. Moreover, the uncertainty of participation rates in turn creates uncertainty for a variety of costs associated with voluntary individual account plans. For instance if individuals accurately perceive any built-in incentive in the benefit offsets, given their personal circumstances, and make their participation decision accordingly, then adverse selection could result. This occurs when certain groups of individuals (for example, those with longer life expectancies) are more (or less) likely to participate than others and when such participation patterns result in a net cost to the government.

#### **DESIGN CONSIDERATIONS IN THE ACCUMULATION PHASE**

A system of individual accounts would provide workers with opportunities to assert greater control over their retirement savings. Therefore, when designing a system, critical decisions would need to be made about who will manage and invest funds and what investment choices will be offered. These decisions, in part, would determine the cost and complexity of the system and the degree of public education needed. Moreover, offering the level of customer service found in the private sector, such as frequent deposits and accessibility of account information, would add costs and administrative complexity to a system.

#### **Options for Investment Management**

Alternatives for designing the investment structure of a system of individual accounts range from offering the individual a limited number of preselected funds, such as those offered by the federal Thrift Savings Plan (TSP), to offering a broad array of private market choices, such as those available through IRAs. Options for managing these investment choices could vary from a centralized, government-managed system to a decentralized, privately managed system. A centralized system would take advantage of economies of scale, which is to say that the more accounts managed by a single entity, the lower the cost for each; thus such an approach could have lower administrative costs than a decentralized system. This is especially important when considering that a number of individuals may initially have small account balances. Depending on how administrative costs are assessed, administrative costs may eat into the accumulated savings of all accounts but could have a greater impact on smaller accounts.

#### **Tradeoffs Between Investment Choices**

There are trade-offs associated with the range of investment choices offered. When individuals have more investment choices, they have more opportunity to tailor their financial situation to their own tastes and preferences and assert greater control over their personal property. However, with a greater variety of choices comes the possibility that individuals will not choose a diversified portfolio or will simply make a bad selection, thus lessening their retirement income from the individual account. As the range and variety of investment choices grow, so does the range of possible outcomes for individual account returns. This means that a number of individual accounts could perform very well, while others will not perform well at all. This results in increased risk to the government that individuals with inadequate income will turn to the government for support through other programs. In addition, a wider range of investment choices can also lead to higher administrative costs, which, if not offset by significantly higher returns, could undermine retirement income for individuals. Limiting investment choice would help to minimize risk and administrative costs, but doing so could also limit the possible return on investments. Moreover, limiting choices raises concerns about the role of government in selecting the investment vehicles and the possibility of political influence over these selections. Essentially, the challenge becomes finding the right balance between individual choice and the related risks and costs to the individual and the government.

Investment decisions become more complicated as the number of choices increase. If individuals do not make an investment choice, managers would need to decide how to invest the contributions for those individuals. Some have proposed placing these contributions in the lowest risk accounts. One such option would be to place these contributions in a limited number of funds and then weight individual portfolios differently depending on the age of the worker, similar to a life-cycle fund, so that workers increasingly assume less risk as they neared retirement.

Public education about the choices available and the risks associated with each would be needed under any system. However, the need to educate the public about the consequences of using different investment strategies would be less under a system with limited choice than under a system with a broader range of choice. When the number of choices is limited, the degree of risk is more defined and the program

is less complex. However, as the number of choices increases, the public would need a greater level of education to learn about the wider variety of investment options, to understand and use the information disclosed to them, and to fully appreciate the consequences of investment choices.

#### **Customer Service Considerations**

Frequent statements indicating the actual account value, daily or periodic valuation of account balances, and the ability to transfer funds between investment options are some of the different services that could be available with individual accounts. When more services and more flexibility are offered, the costs and administrative complexity of managing the investments increase. Moreover, if individuals consider the individual accounts as their personal property, they may expect options and service consistent with those often provided by private sector fund managers, such as frequent detailed account statements and allowing frequent interfund transfers.

#### **DESIGN CONSIDERATIONS IN THE DISTRIBUTION PHASE**

The final design element centers on how the accumulated earnings in individual accounts would be preserved for retirement. Ensuring that retirement income is available for the life of the retiree is a fundamental goal of Social Security. With respect to the distribution phase, individual account systems could use three basic ways to pay retirement benefits: annuitization, timed withdrawals, and lump sum payments. The appropriateness of additional distribution features such as loans or early withdrawals, which are common in 401(k) plans, would also need to be considered. While such features would enhance the account holder's sense of ownership and control, loans or early withdrawals create a risk for leakage of account income that could diminish adequacy in retirement. Further, administrative aspects of the distribution must be considered. These include any guarantees that may be offered as well as the tax treatment of the distributions.

#### **Annuities**

Under a system of annuities, retirees would receive monthly payments for an agreed-upon length of time, and the size of those payments would depend on the total value of the individual accounts. Under individual account proposals, annuities would be obtained either through government agencies or the private market. Further, such annuitization could be mandatory, voluntary, or some hybrid of both. For example, some individual account proposals have suggested mandatory annuitization up to an amount necessary to avoid poverty, and then any remaining account monies could be distributed at the account holder's discretion.

Mandatory annuitization could help ensure that the accounts provided retirement income for the entire remaining lifetimes of participants. Mandatory annuitization of accounts could also minimize adverse selection. Adverse selection occurs, for example, when only healthy people buy annuities and on average live longer than non-buyers, driving up the cost of annuities. According to one study, annuity prices in a voluntary environment can be as much as 14 percent higher than they would be if every retiree were required to purchase an annuity. However, mandatory annuitization also effectively transfers income from the shorter-lived to those that are longer-lived.

Additional design considerations for annuities include the type of annuities that could be offered. For example, monthly income can be a fixed amount per month (fixed annuity); a steadily increasing amount based on an index, such as the Consumer Price Index (indexed annuity); or a variable amount based on returns from investing the premium (variable annuity). Under a single-life annuity, the annuitant receives a guaranteed stream of payments that end with the annuitant's death. Under a joint and survivor annuity, the payments continue to be made, sometimes at a reduced rate, to a second annuitant, such as a spouse, on the death of the primary annuitant. For a term-certain annuity, payments are not contingent on the annuitant's life; instead, they are guaranteed for a specified period of time, such as 5 or 10 years. With a variable annuity, the annuitant assumes some of the risk from the investment returns on the annuity.

The current Social Security retirement benefit provides a fixed lifetime annuity that increases with inflation. In addition, Social Security provides auxiliary benefits to workers' eligible spouses, children, and survivors without reducing the size of the worker's own annuity. While annuity providers could potentially replicate some of the features of Social Security benefits, some important features would not likely be replicated. Adding components such as inflation indexing or a joint and survivor annuity will require the primary annuitant to accept less monthly income than under a single-life annuity. Furthermore, individuals with small account balances at retirement could have difficulty purchasing annuities in the private sector insur-

ance market. Insurers may find provision of annuities to be inefficient and costly for individuals with small accounts because of the relatively high cost of issuing monthly checks and other administrative costs.

#### **Timed Withdrawals and Lumps Sums**

Other options for the payout of accounts include timed withdrawals (also referred to as self-annuitization) and lump sum payments. In a timed withdrawal, retirees specify a withdrawal schedule with the investment manager or record keeper. Each month, they receive their predetermined amount, while the balance of the individual account remains invested. Under a lump sum payment option, individuals may liquidate their accounts through a single payment at retirement and choose to spend or save their money according to their needs or desires. Both timed withdrawals and lump sums give the individual the most immediate control of their account. Such options also underscore that increased personal choice comes with increased personal responsibility if the retirement income is to be preserved for the long term.

#### **Guarantees**

A unique distribution phase design feature of some proposals involves a guarantee of a certain benefit level at retirement. This guarantee could be provided in tandem with other benefit structure changes such that the worker would be guaranteed a minimum benefit. One such approach would guarantee the current Social Security defined benefit. If the individual account provided less than the current benefit, then the system would ensure that benefits were provided to fill the gap. Such an arrangement might be desirable from a benefit adequacy perspective but would require safeguards against the government becoming an insurer of excessive risk taking by individuals. This risk taking could occur if individuals assumed unwarranted investment risk knowing that the government would still guarantee a minimum benefit or rate of return.

#### **Preretirement Access**

While the above design features consider design options in the distribution phase at retirement, individual account design may also consider whether to allow preretirement access. For example, most 401(k) pension plans allow participants to borrow against their pension accounts at relatively low interest rates. In past work we have shown that preretirement access improves participation in 401(k) pension plans and might also be an incentive for participation in a system of voluntary individual accounts.<sup>6</sup> However, those plan participants who borrow from their accounts risk having substantially lower pension balances at retirement and, on average, may be less economically secure than nonborrowers. While some may argue that individuals should be allowed the freedom to access income through borrowing from their accounts before retirement, the added complexity and potential diminution of retirement income need to be given serious consideration.

#### **Tax Treatment**

Any payout option, whether pre—or postretirement, would need to consider the tax treatment of the individual account distribution. Benefits from individual accounts could be taxed in a variety of ways. For example, individual account benefits could be taxed like current Social Security benefits. Persons who currently receive Social Security benefits and have income over a certain amount may have to pay taxes on their benefits.<sup>7</sup> Generally, the higher one's total income, the greater the taxable part of one's benefits. Typically, up to 50 percent of one's benefits will be taxable. However, up to 85 percent can be taxable if, for example, a person filed a federal tax return and one-half of his or her benefit and all other income exceeds \$34,000. Alternatively, individual accounts could be taxed similarly to ordinary income. Individual accounts could also be treated like pension payments (such as DC pensions like 401k plans) or annuity payments from a qualified employer retirement plan, which may either be fully or partially taxable, depending on the type of retirement plan.

<sup>6</sup>Participants in plans that allow borrowing contribute, on average, 35 percent more to their pension accounts than participants in plans that do not allow borrowing. See GAO, *401(k) Pension Plans: Loan Provisions Enhance Participation but May Affect Income Security for Some*, GAO/HEHS-98-5, (Washington, D.C.: Oct. 1, 1997).

<sup>7</sup>Individual income tax filers pay this tax if their adjusted gross income plus tax-exempt interest income plus one-half their Social Security benefits exceeds \$25,000. A married couple filing jointly will pay the tax if this income exceeds \$32,000. These levels are not adjusted for inflation, so the percentage of beneficiaries paying tax on Social security benefits is expected to rise in the future.

## CONCLUSIONS

Clearly, the wide range of possible options complicates the design of an individual account system. In general, our work shows that the features that provide additional flexibility and choice may increase system costs. Such features would include making participation voluntary, rather than mandatory, and expanding the number of investment options.<sup>8</sup> Other key decisions also have cost implications. For example, the contribution phase, the accumulation phase, and the distribution phase could each be administered in a centralized or decentralized manner, and at various levels by the government or by private contractors. In general, costs of individual accounts will rise with increasing decentralization.

No matter what sort of features individual accounts include, any related administrative, management, and data systems must be developed and tested before the individual accounts are made available to American workers. If reforms are implemented with haste and key administrative functions are neglected, the ensuing problems have the potential to undermine an otherwise well-designed accounts system. The federal Thrift Savings Plan has been suggested as a model for providing a limited amount of options that reduce risk and administrative costs while still providing some degree of choice. While using this existing model could mitigate administrative issues, a system of accounts that spans the entire national workforce and millions of employers would be significantly larger and more complex than the TSP.

The choice to include individual accounts as part of broader reform could fundamentally alter the defined benefit aspect of current Social Security benefits. Under its current structure, Social Security redistributes benefits to lower-income workers. Mirroring the redistributive effects of the current Social Security program, individual accounts could be designed to include some progressive features. However, it is important to distinguish between progressivity and benefit adequacy. Greater progressivity is not the same thing as greater adequacy and may result in less equity. As a result, any evaluation of a Social Security reform proposal that includes individual accounts should consider not only the overall costs to the system but also, very importantly, the impact on individuals and families. Administering the accounts and educating the public about a system of individual accounts requires difficult choices and trade-offs; and these choices will determine the degree and speed of public acceptance. Ultimately, what matters most is that we maintain a strong retirement security system for the millions of American workers and their families.

Mr. Chairman and Members of the Subcommittee, this concludes my prepared statement. I would be happy to respond to any questions you or the other Members of the Subcommittee may have.

## GAO Contacts and Staff Acknowledgments

For further information regarding this testimony, please contact Barbara D. Bovbjerg, Director, Education, Workforce, and Income Security Issues, on (202) 512-7215. Blake Ainsworth, Alicia Cackley, Charlie Jeszeck, Michael Collins, and Charles Ford also contributed to this statement.

## RELATED PRODUCTS

*Social Security Reform: Answers to Key Questions.* GAO-05-193SP. Washington, D.C.: May 2005.

*Options for Social Security Reform.* GAO-05-649R. Washington, D.C.: May 6, 2005.

*Social Security Reform: Early Action Would Be Prudent.* GAO-05-397T. Washington, D.C.: Mar. 9, 2005.

*Social Security: Distribution of Benefits and Taxes Relative to Earnings Level.* GAO-04-747. Washington, D.C.: June 15, 2004.

*Social Security Reform: Analysis of a Trust Fund Exhaustion Scenario.* GAO-03-907. Washington, D.C.: July 29, 2003.

*Social Security and Minorities: Earnings, Disability Incidence, and Mortality Are Key Factors That Influence Taxes Paid and Benefits Received.* GAO-03-387. Washington, D.C.: Apr. 23, 2003.

*Social Security Reform: Analysis of Reform Models Developed by the President's Commission to Strengthen Social Security.* GAO-03-310. Washington, D.C.: Jan. 15, 2003.

<sup>8</sup>See GAO, *Social Security Reform: Information on Using a Voluntary Approach to Individual Accounts*, GAO-03-309 (Washington, D.C.: Mar. 10, 2003), and GAO, *Social Security Reform: Implementation Issues for Individual Accounts*, GAO/HEHS-99-122 (Washington, D.C.: June 18, 1999).

*Social Security Reform: Information on Using a Voluntary Approach to Individual Accounts.* GAO-03-309. Washington, D.C.: Mar. 10, 2003.

*Social Security: Program's Role in Helping Ensure Income Adequacy.* GAO-02-62. Washington, D.C.: Nov.30,2001.

*Social Security Reform: Potential Effects on SSA's Disability Programs and Beneficiaries.* GAO-01-35. Washington, D.C.: Jan.24,2001.

*Social Security Reform: Information on the Archer-Shaw Proposal.* GAO/AIMD/HEHS-00-56. Washington, D.C.: Jan. 18, 2000.

*Social Security: Evaluating Reform Proposals.* GAO/AIMD/HEHS-00-29. Washington, D.C.: Nov.4,1999.

*Social Security: Issues in Comparing Rates of Return with Market Investments.* GAO/HEHS-99-110. Washington, D.C.: Aug.5,1999.

*Social Security Reform: Implementation Issues for Individual Accounts.* GAO/HEHS-99-122. Washington, D.C.: June 18, 1999.

*Social Security: Criteria for Evaluating Social Security Reform Proposals.* GAO/T-HEHS-99-94. Washington, D.C.: Mar.25,1999.

*Social Security: Different Approaches for Addressing Program Solvency.* GAO/HEHS-98-33. Washington, D.C.: July22,1998.

*Social Security: Restoring Long-Term Solvency Will Require Difficult Choices.* GAO/T-HEHS-98-95. Washington, D.C.: Feb.10,1998.

---

Chairman MCCRERY. Thank you, Ms. Bovbjerg. Mr. Lockhart, first I want to commend you and Commissioner Barnhart on your efficient and results-oriented management of Social Security programs. Because of the aging of the population and the new responsibilities you have under the Medicare Modernization Act (P.L. 108-73), the President requested a 7.5-percent increase in your appropriation for administration in 2006, and I am pleased that the Committee on Appropriations was able to grant almost all of that request, and the bill will be on the floor today. So, congratulations.

Mr. LOCKHART. Thank you.

Chairman MCCRERY. Would you comment on the support that the SSA could give to an independent board or other entity that Congress would establish to administer personal accounts? Does the SSA already do a lot of the work that would be done ordinarily by such a board? If so, could that be dovetailed with their work to reduce the administrative expenses?

Mr. LOCKHART. Most definitely we could be very helpful in this process. Certainly, as I mentioned in my testimony, in the collection phase, using our present annual wage reporting system would reduce the cost very significantly. We also have, as you know, 65,000 people, a very big tele-service operation, and field offices all over the country, which are very experienced in education. As you mentioned, right now we are in the process of educating the American people about the Medicare Drug Benefit Extra Help Program. So, we have a lot of experience, and we could use our own people or use the additional people that might be hired for this. I think we would be very helpful in the education phase, the enrollment phase, as I said, the contribution phase, and potentially even in the payout phase.

Chairman MCCRERY. Thank you. In the next panel, we are going to hear from a witness who says that due to a large number of small employers, a TSP-type model of personal account administration, as proposed under the President's Commission to Strengthen Social Security, and several other proposals, would have much higher administrative fees than is currently being estimated by So-

cial Security's actuaries. Do you agree or disagree with that assessment?

Mr. LOCKHART. I really disagree. I have close to 30 years experience in the world of pensions; I have sat on big company pensions Committees, and boards; I have actually started a 401(k) for a small business, so, I have a lot of experience in this area. My sense is the 401(k) small business model is not the one we would follow here. The costs of that model are reasonably high, and a lot of it has to do with the burden of regulations and other things that have to be encompassed. The model that I think would make sense would not be that model, but a much more centralized model, using again, the annual wage reporting system and something like the TSP. In fact, the TSP already has systems in place that probably could be scaled up to the size of the Social Security program.

Chairman MCCRERY. You touched on the effort to educate seniors with respect to the new drug program under Medicare. Obviously, if we go to a system of personal accounts, people are going to need an education in their investment choices, in the structure of their accounts, participation, benefits, so, they can decide whether or not to enroll. Then once they are enrolled, they need information on the investment opportunities that will be presented to them. What does the SSA already have in place that could be built upon in administering a system of education to inform the public?

Mr. LOCKHART. Well, certainly, Social Security has a Web site that is one of the most visited in government, and I think that would be a real foundation for any educational effort. We have a very large and effective communications group, publications we put out all the time, and we have, again, the field office structure, if we decide to go that way. I would think, to a large extent, we would try to use, not only Social Security, but other government agencies through the Financial Literacy Council that has been created. We would also hope to get nonprofits involved—there are several of them that have been created over the last few years to improve financial education. It can be a country-wide effort. I think the bottom line would be that it would really be great for the country if we could get more education about financial literacy and investment choices.

Chairman MCCRERY. Thank you. Ms. Bovbjerg, you touched on this in your testimony, I am going to see if you want to expound on it a little bit. You talked about the balance between offering more investment choices and the administrative costs associated with offering more choices. Would you like to expound on that just a little bit? Have you, in your own research, come upon a balance that you think would be about right for investment choices versus administrative expenses?

Ms. BOVBJERG. The balance you choose really depends on the purpose of the program, and the proposals for individual accounts, both here and in other countries, have varied widely as to what ultimately they are inclined to achieve. Our main message is that choice costs money. Choice also requires more education. You may want to have more choice for a variety of reasons. If you have more investment choices, you provide a greater range of potential returns. So, while people are under greater risk of having lowered returns than they expect, there are also people who are going to get



higher returns. If you limit that choice, the opportunity narrows from both ends.

I did want to comment that I think that SSA is absolutely well-positioned to be the center of a public education campaign on retirement and Social Security, whatever happens with the Social Security program. I think it is crucial that the SSA work with the U.S. Department of Labor, the U.S. Department of Education, and as Mr. Lockhart says, all the other agencies that are involved in financial literacy and saver education. We, as a government, have not done a good job of this in the past. For everyone did not know the Social Security retirement age was rising. People to this day—the Subcommittee may not believe this—do not know that their pension will be offset if they work in non-covered employment. It is very difficult to get the word out, even on smaller changes that we make to the program. More comprehensive change would require a lot of attention and preparation.

Chairman MCCRERY. Thank you. Mr. Levin.

Mr. LEVIN. Thank you. Welcome to both of you. Mr. Lockhart, I just wanted to comment. You, in your testimony, say you are committed to strengthening and protecting Social Security; that is the lingo that is used. I think a more straightforward way is to acknowledge that private accounts would not strengthen and protect Social Security, but over time would replace them, replace Social Security benefits. That is now even more clear with developments of recent hours, it is privatization replacing Social Security. Have you ever run a TSP program?

Mr. LOCKHART. No, I have not run a TSP program. I ran the Pension Guaranty Corporation, but not the TSP.

Mr. LEVIN. Have you read Mr. Cavanaugh's testimony?

Mr. LOCKHART. Yes, I have read his testimony many times.

Mr. LEVIN. Are you going to be here—you won't be here, I suppose, when he gives his testimony.

Mr. LOCKHART. No, I have another meeting.

Mr. LEVIN. He has run the TSP, as you know, and he has very different ideas than your gloss about how relatively easy it would be. So, it would be useful if you would take his testimony and give us your response. Will you do that?

Mr. LOCKHART. Well, first of all, we will certainly give you a detailed response, but I can give you some—

Mr. LEVIN. I would like you to go through it—I don't know if you have read it today, but give us a written response. Can you do that?

Mr. LOCKHART. I would be happy to. I can also say that we have met with the TSP many times, including its chairman, the Executive Director, and their systems contractors. Mr. Cavanaugh was there in the startup phase, and now this is 20 years into the program. So—

Mr. LEVIN. Startup, he was there until 1994, right? He was here from 1986 to 1994.

Mr. LOCKHART. Right.

[The information follows:]

Mr. Cavanaugh states that "the Administration's estimate of 30 basis points is optimistically low. . . ." To be clear from the outset, the Administration makes no estimates of personal account administrative costs. Rather, it relies upon estimates and

projections from the independent, non-partisan Office of the Chief Actuary at the Social Security Administration (SSA).

Mr. Cavanaugh argues that similar low-cost estimates for the administration of personal accounts have been based on large-employer 401(k) plans or the TSP which are unrealistic for consideration as PA models. Instead, he contends the small business corporate 401(k) model is a better predictor of administrative costs and burdens. He illustrates his point by citing an annual \$3,000 cost to employers for maintaining a 401(k) plan—a cost he states that many small employers can not afford. Mr. Cavanaugh also discusses other issues he believes would be barriers to implementing a PA system, including the difficulty of making timely investments and problems communicating with large numbers of system participants.

Despite Mr. Cavanaugh's claims, personal accounts need not be modeled after small business 401(k) plans. Under existing 401(k) rules, employers not only decide investment options available to employees under their plans, but also assume costs for ERISA compliance, setup expenses, payroll administration, investment selection, and funds reporting. Despite differences pointed out by Mr. Cavanaugh, personal accounts could follow the Thrift Savings Plan (TSP) model, where a central administrative agency would relieve the employers of these administrative burdens.

A centrally administered system could collect account contributions through the existing payroll deduction and wage reporting processes. The calculation of contributions, transfers of money, and crediting of personal accounts would occur between Treasury, SSA, and the PA administrator. Employers would have no new administrative responsibilities under this scenario because they would continue to deposit and report payroll taxes as they do today.

Mr. Cavanaugh's numbers are highly inflated because he uses the decentralized small business 401(k) model. Many of the cost studies that use a centralized, simple PA model have mature cost similar to Social Security's actuaries. The Employee Benefit Research Institute study 1998, which he cites as backing his conclusions, also had a low cost scenario of 10 basis points.

Although Mr. Cavanaugh is correct that the current wage reporting system identifies individual employees and self-employed workers only once a year, this would not preclude a PA system from providing participants with earnings on their contributions throughout the reporting period. Contributions could be deposited in a "holding" fund where they would accrue interest until the reporting and reconciliation process is complete each year. The contributions plus interest earned would then be credited to the individual accounts and invested in the funds of choice.

Mr. Cavanaugh exaggerates the inability of small businesses to report wages. He states that 72 percent of employer reports are on paper and implies employers with 68 million employees would have difficulty reporting. Social Security has a major effort underway to increase electronic W-2 reporting, and we now receive nearly 61 percent of W-2s electronically. Only 21 percent or 48 million W-2s are filed in paper form and many of these are printed from small business computer accounting systems. We have a successful, rapidly growing and award winning W-2 online system that is designed for businesses with under 20 employees, it is helping to reduce the cost of annual wage reporting. We would expect a major increase in electronic reporting by the time PAs were implemented. Electronic reporting would allow more timely wage reporting for PA account purposes.

Communications is another issue raised by Mr. Cavanaugh that lends itself to central administration. It is worth noting that TSP receives over one-half of its inquiries on loan-related issues. The President's proposal would not allow such loans and would likely generate fewer inquiries on a participant percentage basis. A focused educational campaign developed by a PA central administrator could reach virtually the entire U.S. population through the use of the Internet, television, radio, and print materials. In addition, a PA administrator could seek voluntary assistance in delivering the educational information from employers, unions, professional associations, financial educational associations and other government agencies.

The 30-basis-point cost estimate cited by Mr. Cavanaugh was in the final report of the President's Commission to Strengthen Social Security and was provided by the Office of the Chief Actuary of SSA.<sup>1</sup> This figure applies to a mature system of personal accounts, but is still significantly higher than the TSP's 6 basis point cost. The estimated cost reflects realistic assumptions for a system having a much broader participant universe and more limited administrative features than the TSP. A centralized system would realize large cost-savings as the result of aggregating the contributions of virtually the entire U.S. workforce into a single, low-cost, limited-

<sup>1</sup>President's Commission to Strengthen Social Security. 2001. Strengthening Social Security and Creating Personal Wealth for All Americans, p. 97.

option system of personal accounts, regardless of the size of individual employers. Due to the potential economies of scale, in my opinion even the ultimate 30-basis-point estimate for the cost of personal accounts may prove to be high in the long run.

Setting up a system to accommodate millions of participating workers would entail certain initial costs. However, administrative costs would decline as a percentage of assets under management as the system matured, startup expenses diminished, and assets accumulated. As an example, the administrative costs of the TSP declined from roughly 30 basis points in 1988 to about 6 basis points in 2004, while adding numerous new capabilities.

The differential between TSP and PA administrative costs would be less than predicted by Mr. Cavanaugh. While the TSP has the benefit a single employer as payroll agent, the existing SSA wage reporting process could provide a single interface between PA participants and the program's central record-keeper. Therefore, if the existing wage reporting process were to be used, relatively little additional up front administrative cost would be incurred under a PA plan.

In addition, most PA proposals call for fewer participant services and options than the TSP simplifying administrative tasks and reducing costs. Annual contributions would be fixed by wage level, whereas TSP participants can alter what they contribute. PA account statements could be issued annually or quarterly and changes to investment allocations could be limited, rather than allowed daily as under the TSP. In addition, a system of PAs would not provide for loans or early withdrawal of account assets, both of which are currently available in the TSP and are major cost drivers to that program. All of these factors would reduce PA administrative costs relative to a 401(k) model and keep them closer to those of the TSP. As with the TSP, more capabilities could be added over time.

The current centralized administration of Social Security provides direct evidence that Federal administrative costs for PAs could be kept quite low. SSA provides efficient and effective service to the public and employers while administering the complex Social Security and Supplemental Security Income programs at very low cost. The Agency manages staffing, facilities, automated systems, and business processes with the capacity to service virtually the entire U.S. workforce of 159 million people. As example of Social Security's efficiency, the annual "Social Security Statement" is mailed to 144 million people at a per statement cost of 38¢. The undeliverable mail returns are less than 4 percent, much lower than the 25 percent that Mr. Cavanaugh stated in his testimony.

Based on his questionable small business model, Mr. Cavanaugh arrives at a questionable recommendation, for direct investment in corporate stocks and bonds by the trust fund. If done in any significant size, as a CBO policy brief <sup>2</sup>stated, "Government ownership of stocks could affect corporate decisionmaking, interfere with the nation's competitive market system, and impede the efficient operation of financial markets—potentially limiting growth". Despite Mr. Cavanaugh's contention, direct investment by the trust fund in the equities markets would have precisely the same transition issues as would personal accounts. There is no "multi-trillion dollar transition cost" that distinguishes individually owned investment from government-controlled investment.

In conclusion, Mr. Cavanaugh raises certain administrative cost issues that are important factors in the discussion of creating personal accounts. However, when examined closely, none of those issues appear to be obstacles for the implementation of PAs. Looking beyond premium-service small business 401(k) plans offered by some plan managers, the low administrative costs of the TSP and basic-service 401(k) plans provide better cost models for designing personal accounts.

Mr. Cavanaugh's assertion that "the Administration's plan for universal PAs is not feasible—" is inconsistent with the experience of the TSP, large company 401(k) plans, the experiences of other nations, and the findings of non-partisan analysts ranging from the Social Security Administration Office of the Actuary, to the Congressional Budget Office. We believe that this inconsistency is based largely on Mr. Cavanaugh's adoption of a number of assumptions that do not reflect the personal account proposals that have been put forward by the Administration or by many Members of Congress.

---

<sup>2</sup> Congressional Budget Office, *Acquiring Financial Assets to Fund Future Entitlements*, June 16, 2003, p. 1.

Mr. LEVIN. All right. Ms. Bovbjerg, let me just ask you: It has been suggested that some of the payroll taxes that are placed in the form of Treasury bonds would be given to private accounts holders. If that were to happen, would the cash still be in the Treasury?

Ms. BOVBJERG. It would depend on how the bill is written. I have not seen bill language, but I think it would be important to know where the cash goes, what the interactions are between the rest of the government, the trust fund and individual accounts, how that is scored from a budgetary perspective—

Mr. LEVIN. If bonds are given to individual holders, the cash remains in the Treasury, doesn't it?

Ms. BOVBJERG. I am not sure how to answer that question because I have not seen the language in the bill.

Mr. LEVIN. How would it not be in the Treasury if simply you give bonds to private account holders?

Ms. BOVBJERG. Well, I am not sure that that is the only thing that is envisioned. I haven't seen it.

Mr. LEVIN. Say that is envisioned.

Ms. BOVBJERG. If that is the only thing, if you just give bonds, it is only a promise to pay later, you are correct.

Mr. LEVIN. That money could continue to be used for any purpose this Congress decided, right?

Ms. BOVBJERG. Correct.

Mr. LEVIN. Okay. Now let me ask you about annuitization; mandatory versus voluntary. If annuitization is mandatory, is there anything that a holder of an annuity policy can pass on to heirs?

Ms. BOVBJERG. No. Unless it is a joint and survivor annuity.

Mr. LEVIN. Unless it is joint and survivor. If there isn't that provision, there is nothing to pass onto heirs, right?

Ms. BOVBJERG. Jim reminds me that there are different kinds of annuities, but I was thinking of a lifetime annuity, and for a lifetime annuity, that is correct.

Mr. LEVIN. All right. My time is up. Thank you.

Chairman MCCRERY. Mr. Shaw.

Mr. SHAW. Mr. Levin asked if the cash coming in as surplus goes to the Treasury and bonds are issued, where is the money? Well, obviously at that point it would be in the Treasury. If the money or the surplus was invested in the private sector, then the money would be in the private sector or the bond or stock, whatever it would be, it would be in the individual accounts. Or third, the surplus could just simply be put into a vault and not draw any interest at all, which would just be damn stupid. Now, is there anything else that can be done with the money that you can think of, either one of you, other than just let it go? The Social Security law was written in a way that requires, at this particular time, the money that is not spent be placed in a government-backed security. That is what the law says; is that not correct?

Mr. LOCKHART. That is correct.

Mr. SHAW. So, you don't have the privilege right now to go out and invest in the private sector or to make it like a thrift account, you have to put it into the Treasury and you have to receive government-secured—government bonds for that particular cash.

Mr. LOCKHART. That is correct, Congressman.

Mr. SHAW. That cash does draw interest?

Mr. LOCKHART. The cash draws interest, yes.

Mr. SHAW. Now, if the Congress should pass a bill similar to the one that Mr. Levin is referring to, that in no way stops the Treasury bills from going back into the trust fund as they do today. In addition, an additional bond in a negotiable security in the name of the worker is placed into the Social Security so that you actually have two sets of bonds. Now, does that at all affect the liquidity of the trust fund? Remember, we are not disturbing the existing model at all, and there is two bonds being issued on the same money, one as it is today, and then an additional bond with someone's name on it. Would that not, in fact, increase the solvency of the Social Security Trust Fund rather than decrease it? Is that not correct?

Mr. LOCKHART. Again, as Barbara said, I haven't read the legislation, so, it is a little difficult——

Mr. SHAW. Well, nobody has.

Mr. LEVIN. Including you.

Mr. SHAW. It is being written right now, but we have put the details——

Mr. LOCKHART. Well, certainly, from a Social Security Trust Fund standpoint, if there is a bond that is issued to the trust fund, there would be no change. Then, going forward, I don't know the details if there is an offset or other issues—that would all need to be looked at.

Mr. SHAW. The more bonds that are being held by the Social Security Trust Fund, the more solvency you will acquire.

Mr. LOCKHART. That is right, but as you all know, when we come to draw down on those bonds, we have got to go to the U.S. Treasury. We need to get the money, and they are going to have to——

Mr. SHAW. I understand that. That is a problem that we are going to have to be dealing with. I think the question is, and I think the problem that we are trying to address with this new bill—and it is not really fair to be talking too much about it, other than the fact that Sandy opened the door to my questioning in this particular regard. The question is, how do you account to the taxpayer for the surplus that is now being spent by the Federal Government? The answer on the bill that will soon be filed simply says, by putting the taxpayer's name on a negotiable bond that is held in the trust fund, but nevertheless, that that person's name is on it. This is a question of we are not—it is not going to be contribute that much to solvency, in fact, the preliminary figures we are receiving is it only adds about 2 years to solvency. So, it doesn't address the issue that the President wants to address, but it does address one issue, which I think is very important, and that puts ownership into Social Security, which is missing the way Social Security is written now. Thank you, Mr. Chairman. I yield back.

Chairman MCCRERY. Thank you, Mr. Shaw. Mr. Becerra.

Mr. BECERRA. Thank you, Mr. Chairman. Thank you for the testimony, thanks for being here today. Ms. Bovbjerg, I think we are going to be inviting you quite a bit, so, thank you for always willing to be here. Let me make sure I have a correct impression of where we are with the Social Security Trust Fund surpluses. We

are still running significant surpluses in Social Security's account because we are collecting far more than we are having to pay out on a yearly basis, and that is as a result of the changes that were made in the early eighties, because at that point we were approaching a crisis, and this is what President Reagan and Congress decided to do to try to make sure we didn't have to face that problem, and also because of the demographics of the baby boomers, we decided to go ahead and try to resolve the problem into the future as well. We are collecting, what is it this year that we are collecting?

Mr. LOCKHART. Well, an extra \$69 billion in taxes in 2004, and then an additional \$89 billion in interest.

Mr. BECERRA. Eighty-nine billion in interest. It is more than we are collecting in the surplus—in taxes—because we have got so much that has been collecting over time that all those Treasury certificates earning this interest, that totals \$89 billion just this year alone.

Mr. LOCKHART. Right.

Mr. BECERRA. So, the \$89 billion plus the \$69 billion gives us about \$160 billion this year alone that Social Security will have received or earned above what it needs to pay out benefits to those who are currently required or are survivors of American workers who died or are disabled and who qualify for Social Security benefits. That is going to continue on. We right now have an overall collective surplus in the Social Security account of over a trillion dollars, close to \$2 trillion, isn't it?

Mr. LOCKHART. Yes, \$1.7 trillion.

Mr. BECERRA. That's \$1.7 trillion today of surplus money. That is going to continue growing until about what, 2017? To about \$5.6 trillion. My understanding is it will reach over \$6 trillion by 2027 in surplus. That is the money that we will then be able to turn to to make sure we can cover any shortfall between what we collect in workers contributions, workers taxes for Social Security, and what we need, and then start paying out in retirees, survivor, and disability benefits, correct?

Mr. LOCKHART. Well, that is correct. You said money, and I am not sure there is money there. The money will be there when we turn in the bonds and get it from the U.S. Treasury—and Treasury has to go raise the money, and that will be in the form of borrowing new money or increasing taxes.

Mr. BECERRA. So, let me make sure about something, Mr. Lockhart; are saying that you don't believe that those Treasury certificates will be redeemable?

Mr. LOCKHART. No. I believe they will be redeemed, I am just telling you how they have to be redeemed.

Mr. BECERRA. So, are you telling me that they are not as good as money?

Mr. LOCKHART. I am telling you that they are as good as the credit of the United States, and the credit of the United States is the power to tax the American people.

Mr. BECERRA. So, unless you are telling me that you believe that a President or Congress in the year 2027 or so, or 2017, is going to change his or her philosophy and say we don't wish to

repay those Treasury certificates that American workers helped create, it is as good as money.

Mr. LOCKHART. It is as good as money, yes, at that point.

Mr. BECERRA. I think that is important because, if indeed the American public today is contributing this money for Social Security, their Social Security, their parents' Social Security or grandparents' Social Security, who are today retired, and for their kids Social Security, who will be working in 20 years and not retiring for 50 years, I think they want to know that these Treasury certificates will be there into the future.

Mr. LOCKHART. Right. Well, the money has been spent as you know, so, it will be new money in the future that will have to be raised to redeem the bonds.

Mr. BECERRA. You raised a point. Money has been spent, and there has to be future money raised. You do believe that the money will be raised to pay for all the expenses of government, correct?

Mr. LOCKHART. Certainly.

Mr. BECERRA. Okay. In terms of money being spent, when President Bush took office in 2001, he had an operating surplus where we didn't have to touch the Social Security surplus moneys in order to pay for all the expenses of government, correct?

Mr. LOCKHART. Well, the budget that he inherited already had the deficit—

Mr. BECERRA. In 2001, if I recall—Mr. Lockhart, let me make sure about something. Correct me if I am wrong. In 2001, we experienced the largest budget surplus this country has ever witnessed, correct? Which meant we didn't have to touch Social Security surplus moneys. The President, in his State of the Union Address in 2001 said, we have enough money that we can do tax cuts—for mostly to wealthy folks—and we won't have to touch a cent of the Social Security surplus. Yet, every year we have touched and spent the Social Security surplus. So, it seems to me that what we need to do is figure out ways to have an operating budget, the one we had before, where we didn't touch Social Security surpluses, versus figuring out how to take the money out of the Social Security Trust Fund and use it for private accounts. If we are trying to protect surplus money, you don't need it put into personal accounts, you just don't have to spend it on other activities.

Mr. SHAW. Will the gentleman yield to me on that point?

Mr. BECERRA. Certainly.

Mr. SHAW. This Committee had hearings on that very subject, and what we did, in fact, we used the surplus to pay down the general obligation debt of the United States. So, what we did was to take the surplus cash coming in from Social Security, as well as from taxes, and paid down general obligation debt.

Mr. BECERRA. Mr. Shaw, I think you are right, that may have happened a little bit in 2001, but quickly thereafter, we now have seen nothing but massive deficits. So, today, none of the money that is in the Social Security surplus that is being used by the Bush Administration is being used to pay down debt. In fact, we are seeing debt increase more than we have ever seen in the history of this country. It is even with the use of all the Social Security surplus moneys that we still see debt and deficits, annual defi-

cits growing at massive rates. Thank you, though. I appreciate your responses.

Chairman MCCRERY. Thank you, Mr. Becerra. Mr. Hayworth.

Mr. HAYWORTH. Thank you, Mr. Chairman. Hearings, of course, are very useful to draw on both the experience and expertise of the witnesses, but they also offer incite a recent understanding of history and the perception that, of course, departs from policy and becomes purely political. I welcome the assessment of my friend from California because, carefully ignored in his formulation of question was the sudden and brutal attack on the American people of 9/11, and all the commensurate economic difficulties, not to mention national trauma and challenges that this Nation confronts in the wake of that. Certainly, we are all entitled to offer instant revisionism of history, or to ignore part of the challenges that led to the current economic situation. One thing that I thought was interesting, in recent weeks, and in terms of the way the agenda is set, and certainly in a free press, it can be buried back in the news sections, and maybe some who join us today, Mr. Chairman, failed to notice, but I believe I heard in the litany from my friend from California the refrain of tax cuts, mostly to the wealthy, which we hear time and again.

Of course, what we discovered recently is that revenues to the government actually increased. Yes, we have challenges that abound, but certainly the crux of the argument simply comes down to this: As we hear concerns about trying to deal with the coming demographic challenges that Social Security will confront, we do have a choice—I guess we could go back to what was done in 1982, and certainly at least one Member on the other side of the aisle to his credit has offered one plan which calls for dramatic payroll tax increases, and that is an option that we are free to pursue. Or perhaps we ought to look—and this, again, is just more a question of philosophy than policy, although it has great consequence for policy—we can raise taxes, and indeed there are those that believe in that command control, but there is a consequence to that, that may not result in the great economic expansion that we have seen historically when marginal tax rates are reduced, it fires the engines of economic opportunity and actually increases revenues to the government. So, there are different choices here.

Again, we welcome the chance for a hearing and the chance to see legislation put forth, not as some of my former colleagues in journalism; rather than who, what, when, where, and why, offer their own analysis and say this is an exit strategy. I thought my friend from Florida made it very clear, the ideas put on the table yesterday and the legislation being formulated there is an entrance strategy to try and confront this very real challenge. Of course, to the extent that policy is predicated on politics, there is that holding pattern—I am using a diplomatic turn, others might more accurately define it as obstruction and no, no, no, no, no, no, no—which some may feel strategically politically offers an advantage in the 2006 elections, doesn't do much for our kids and what transpires in coming years, but it is interesting to get that insight. I see my time is about to expire. Mr. Chairman, I ask your indulgence. Just one question to Ms. Bovbjerg here. Given the experience of the Fed-



eral TSP and private sector defined contribution employer pension plans, how many investment choices are workers usually provided?

Ms. BOVBJERG. It varies tremendously, it really does. The TSP, I know, has currently five different funds, and I think one of the things we have talked about in various work we have done is a way to look at the range that you can provide that at the same time offers some structure, some protections for people who might otherwise invest unwisely.

Mr. HAYWORTH. You offered a cautionary note in your testimony that I heard briefly. At what point do you think the administrative and personal costs associated with increasing the number of investment options outweighs the benefits of having those options?

Ms. BOVBJERG. I am not really the person to judge that; that is really a policy decision for the Congress. You must consider whether it is more important to allow people to earn higher returns but with assuming greater risk and how much you think you want to spend in administrative costs. These are really the trade offs; the more choice, the more it will cost to manage it.

Mr. HAYWORTH. That is one of the challenges. Mr. Lockhart, your assessment of—

Mr. LOCKHART. Well, in my experience, many 401(k) plans offer a lot more options than the five that the TSP does. Some of the studies I have seen show that if you offer too many choices it confuses people, and they don't actually even sign up for a 401(k). So, you have to be careful about offering too many choices. The TSP range is pretty extensive—it really covers the total U.S. stock market and bond market, and also the international stock market. So, with those five funds, you really capture a large part of the investment world.

Mr. HAYWORTH. Thank you, both. Thank you, Mr. Chairman.

Chairman MCCRERY. Thank you, Mr. Hayworth. Mr. Hulshof.

Mr. HULSHOF. Thank you, Mr. Chairman. As a quick aside, I would say to my friends from Michigan and California, you might want to rescue your colleague from New York, because I think Mr. Ryan is actually making some headway with Mr. Rangel.

Mr. LEVIN. I am not worried.

Mr. HULSHOF. I don't know, they have been pretty animated.

Mr. RANGEL. Paul Ryan makes a lot of sense because he is the only one that is discussing Social Security with me on the Republican side.

Mr. RYAN. You are getting me in trouble again.

Mr. HULSHOF. Mr. Chairman, if you don't have any pride in authorship, a Ryan-Rangel bill sounds pretty good.

Mr. LEVIN. I don't think you would like it.

Mr. HULSHOF. I do want to make a good point, and Mr. Becerra is a good friend and a colleague, and we have had a number of hearings, and you have consistently made the point about excess payroll taxes and what has been done with them. You and I have bantered back and forth about what happened in the 1990s, and then of course we did have a period of surpluses, operating budget surpluses to use your term, and so, that is why I think possibly what has been discussed in the last 24 hours or 48 hours, as far as taking those excess payroll taxes, those surplus funds that

are coming in, as you pointed out, all the way through 2017 and allowing those to be used in a personal account for those who choose them—again, we are talking about possible voluntary accounts. Ms. Bovbjerg, let me just go directly to your written statement. On page six, you aptly point out that voluntary individual accounts would require additional considerations that mandatory accounts don't. What I wanted to do was, and then you go on to state—and again, for the record, since I know that this is being seen by others, Members of Congress do pay into Social Security—I know there is a misnomer out there that we don't. We do, but we do have the TSP.

What I wanted to ask each of you, or either of you is, Ms. Bovbjerg, you suggest that workers might be offered the opportunity to opt in and out of participation periodically, in other words, it is not just a one-time decision that I am never going to participate, but you might see, for instance, a co-worker who chooses to opt in that might see their portfolio, this nest egg begin to grow, and they might decide well, I am missing the boat here. I know Members of Congress have the option to opt out of Thrift Savings; they don't have to take Thrift Savings, but then they are allowed to participate as they wish in certain additional amounts of contributions. What would be some of the advantages or disadvantages of allowing those who, making that decision to participate, allowing them to enroll or disenroll periodically? What additional challenges would we have if we were to allow that periodic opting in and opting out?

Ms. BOVBJERG. It is partly a recordkeeping issue, particularly if people are in and out, depending on how they are feeling about the market. It is one thing to run—the TSP is relatively small compared to what we would be talking about, to run something like that and keep the records, it is a little different thing when you are with two million people that they are keeping records for. The SSA does really well at keeping records for about 270 million members, but you would then have to track whether you are accepting contributions, what is happening with their investment. It would just complicate things. It is not that it is impossible by any means, it just makes it a little bit more complex. Your education effort is a little different, it is not: okay, I have to decide by next week if I am going to do this or not, and that is it. If it is in and out, you are going to have a more ongoing educational effort.

Mr. HULSHOF. Again, Mr. Lockhart, I want to get to you before my time expires. For instance, again, the TSP, for folks who don't understand the voluntary option that we have, there are certain periods of time called open season, for instance. We know that that is coming, it has been an educational process, but we know that during this, say, 30-day calendar period of time, we could choose to change—in fact, though, it is even to the point where technology would allow us, I think daily, should we choose to, to change the percentage of these five different types of funds—and again, I understand that we are talking about a finite number and then a larger number, but Mr. Lockhart, I think in your testimony you indicated that even with the complexity and the additional numbers, millions of people that might choose this—again, it is voluntary—

we are talking about a cost of, administrative cost of only about 30 basis points; is that right?

Mr. LOCKHART. Yes. That is the ultimate cost that the actuaries forecast. That is on a relatively simple system: if you add more choice over time, it may go up somewhat in cost. Certainly the idea of letting people come into the system over time as they become more knowledgeable is probably a reasonably good idea. Going in and out, as I think Barbara mentioned, could be a paperwork problem.

Mr. HULSHOF. Just as a final point, Mr. Chairman, again, for those in this education process, 30 basis points is 30 cents for every \$100 in the account; is that, in essence, 30 basis points?

Mr. LOCKHART. That is correct.

Mr. HULSHOF. That would be the cost? Thank you, Mr. Chairman.

Chairman MCCRERY. Thank you, Mr. Hulshof. Mr. Rangel. I am going to recognize our distinguished Ranking Member of the full Committee who has joined us. Welcome. You may use your 5 minutes, Mr. Rangel, to pose questions to the panel, or if you would like to give us all a preview of the Ryan-Rangel bill, we would like to hear it. You are recognized.

Mr. RANGEL. I really appreciate this courtesy. I do enjoy talking with Mr. Ryan because we really talk about our differences, and I think that if we did more of that, the Committee would better understand each other and we could take the political questions out of it. I want to deal with Social Security to get a clear understanding as to the new roads that we follow. We had presidential bills, then we had concepts, then we had solvency, then we had personal accounts and private accounts. As you understand this process, the Social Security system in its present form is going to have a fiscal problem in the future; is that correct?

Mr. LOCKHART. That is correct, it is unsustainable.

Mr. RANGEL. The President had the courage to take this complicated political issue, to bring it to the Congress and say that we have to fix it.

Mr. LOCKHART. Yes, he did, and he brought it to the American people as well. I think they have started to get the message that we really do need to do something about Social Security, and do it soon.

Mr. RANGEL. I really think you are going beyond your training in your subjective thoughts, and I think it would depend on what community you lived in, but I will leave that alone. Having said that, we are now dealing with the surplus that we now have, part of that being put into a private accounts, this new idea that we have come up with.

Mr. LOCKHART. Yes, that is what I understand.

Mr. RANGEL. Could you tell me how that deals with the question of solvency, which you believe that Americans are concerned about?

Mr. LOCKHART. Well, certainly President Bush and the SSA has set as a goal achieving sustainable solvency, permanent solvency. I think the Senate in mid March voted—

Mr. RANGEL. I know that, sir. I am just talking about the concept of the surplus that we get, beyond what we are paying the

people. Assuming that when the Baby Boomers come, we won't have that surplus, right?

Mr. LOCKHART. That is correct.

Mr. RANGEL. That is what makes the crisis.

Mr. LOCKHART. In three short years, the annual cash flow surplus begins to decline.

Mr. RANGEL. All I am asking is, how does taking money out of a non-existing surplus, what happens when the surplus goes and you are trying to put a different type of bond in the private account than you have in the so-called trust fund, how does this concept—assuming that I bought the Ryan-Rangel concept, how do I explain that I am taking away the problem of solvency?

Mr. LOCKHART. Well, I am not sure I can comment on the legislation that was discussed yesterday, but I can talk about personal accounts in general if that would help.

Mr. RANGEL. No, please don't do that because every week they come up with a new concept, and as soon as I understand it they have another one. You are the expert, I want you to comment the best you can, because Mr. Ryan understands and he has left, and I only have you.

Chairman MCCRERY. Would the gentleman yield?

Mr. RANGEL. Yes.

Chairman MCCRERY. I am also to be an author of the legislation that is not yet fully drafted, but I would be glad to discuss it with the gentleman. The gentleman has not yet characterized it correctly, and Mr. Lockhart is in no position to comment on the effect on solvency on a proposition that he hasn't seen.

Mr. RANGEL. Well, I haven't seen it either.

Chairman MCCRERY. I will tell the gentleman that we expect the Social Security actuaries to score the bill, the bill we are about to introduce, as increasing solvency by 2 years.

Mr. LEVIN. Would the gentleman yield? If Mr. Rangel would yield?

Mr. RANGEL. This is just such a good answer—

Chairman MCCRERY. It is the gentleman from New York's time.

Mr. RANGEL. If the Chairman would explain, this surplus is going to go the way that we enjoy now; is that correct? When the Baby Boomers come?

Chairman MCCRERY. Yes, sir.

Mr. RANGEL. You announced—someone is saying that out of the surplus, we are going to take the money to fund the private accounts, right?

Chairman MCCRERY. We are going to put the equivalent amount of money of the surplus in personal accounts, in marketable securities, which will be in the name of individuals, yes, sir.

Mr. RANGEL. My question, Mr. Chairman, is what surplus?

Chairman MCCRERY. The surplus of revenues over outgo of the Social Security system. Cash.

Mr. RANGEL. Is it not true that the money that goes into the surplus is going into the General Fund?

Chairman MCCRERY. Yes, sir.

Mr. RANGEL. If you take that surplus and put it into a private account, don't you leave a gap out there for general funds?

Chairman MCCRERY. It depends on how you do that. In our legislation that is not the way we intend to do it, and I will be glad to discuss it fully with the gentleman so he understands it after the hearing. We will have witnesses on the next panel that can expound on various alternatives for doing what the gentleman has described. I look forward to questioning them when they get to the panel.

Mr. RANGEL. I thank you.

Mr. LEVIN. Will the gentleman yield briefly?

Mr. RANGEL. I hope the Chairman would allow me, yes.

Mr. LEVIN. Mr. Shaw indicated there would be two bonds. You asked a good question, how can you transfer the surplus from one place to another and address solvency. I am anxious to see the details, because the only way to do that is to use general funds. We will see. I think it was interesting, Mr. Rangel, that Mr. Shaw gave you an answer we were going to have two bonds. Let's see the details. The fact remains that FICA taxes are being used for private accounts. That is the basic fact. Thank you, Mr. Rangel, for yielding.

Mr. RANGEL. Thank you.

Chairman MCCRERY. Under our legislation, that will not be the basic fact. Mr. Lewis.

Mr. LEWIS. Thank you, Mr. Chairman. Mr. Lockhart, right now, who owns the Social Security Trust Fund? Is there a personal account? Can a Social Security recipient say, this money, this Social Security money, is mine, and I own it, it is owed to me, and the Congress has to make sure that that money is in my personal account?

Mr. LOCKHART. There are no personal accounts in Social Security today. Some people sometimes think there are, but there are none. In fact, it is a pay-as-you-go system, so the taxes I pay go to pay my parents' Social Security benefits.

Mr. LEWIS. Absolutely. We rehash this over and over again, but since we are talking about personal accounts today, retirees do not own their Social Security money.

Mr. LOCKHART. That is correct, and as you know, by law, Congress can change even the benefits under Social Security.

Mr. LEWIS. Any time. Any Congress. It is not secure. It is only secure as long as Congress is willing to make sure that that pay-as-you-go system continues.

Mr. LOCKHART. Correct.

Mr. LEWIS. So, every time I have a townhall meeting, I have people say to me, when are you going to stop spending money out of the Social Security Trust Fund and set it aside for the Social Security recipients? Well, what we are talking about here today is what we are creating, a system now where the money will be set aside, the surplus money will be set aside, and the recipients will be given a key to the box, to the lockbox, and it will not be in the hand of Congress, its key will be in the hand of the recipient, of the constituent. They have been asking for that for a long time.

Mr. LOCKHART. I agree with you. I have probably done 50 or more townhalls with Members over the last year or so—with Democratic and Republican Members, with the AARP and the American Federation of Labor and Congress of Industrial Organizations

(AFL/CIO). That is one of the most common questions you get: Why isn't that money staying in Social Security?

Mr. LEWIS. Exactly. So, going back to Mr. Becerra's question a minute ago, again, we are rehashing this, but when will the Social Security Trust Fund surplus hit the wall and start on the road to insolvency?

Mr. LOCKHART. In 3 years the annual cash flow surplus begins to decline. That is when the first Baby Boomers start to retire. In 12 years there will not be enough taxes to pay benefits. That is when we have to start drawing down the interest on the bonds.

Mr. LEWIS. As Mr. Becerra asked you, will those be paid?

Mr. LOCKHART. I believe they will, yes, sir.

Mr. LEWIS. How will they be paid?

Mr. LOCKHART. There are really only three ways: increasing taxes, borrowing the money elsewhere, or reducing government spending.

Mr. LEWIS. What kind of tax increase will our children have to bear to pay this? It was a great deal when there were 40 people paying in for one person on retirement. Now that it is down to three for one, and eventually two for one, the pyramid is coming to a point here. What kind of taxes are my kids going to have to bear?

Mr. LOCKHART. Well, maybe your grandchildren. Over the 75-year forecast, the independent actuaries' numbers and the trustees' Report shows we will have to increase payroll taxes by 46 percent by the end of the period, if you wanted to continue to pay scheduled benefits. If you don't want to continue to pay scheduled benefits, you would not have to.

Mr. LEWIS. We are going to have, as Mr. Becerra said, those benefits paid. So, it seems to me like my colleagues across the aisle, they have a plan, and the plan is this: We are just going to tax the daylight out of future generations to meet the obligations for Social Security. That sounds like a pretty bad plan to me, and a very risky plan. I yield back my time. Thank you.

Chairman MCCRERY. Thank you, Mr. Lewis. Mr. Lockhart, Ms. Bovbjerg, thank you very much for joining us. We look forward to seeing you again. At this time I call the second panel. We have another distinguished panel to give us their views on personal accounts and how they might be set up and managed. Olivia S. Mitchell, Ph.D., Professor of Insurance and Risk Management, Executive Director, Pension Research Council, and Director, Boettner Center for Pensions and Retirement Security, Wharton School, University of Pennsylvania. Patrick J. Purcell, Specialist in Social Legislation, Domestic Social Policy Division, Congressional Research Service (CRS). Alex J. Pollock, resident fellow of the American Enterprise Institute. Joan Entmacher, vice President and Director, Family Economic Security, National Women's Law Center (NWLC). Francis X. Cavanaugh, former Executive Director and chief executive officer, Federal Retirement Thrift Investment Board. Virginia Reno, Vice President for Income and Security policy, National Academy of Social Insurance (NASI).

We welcome all of you for our hearing today. Your written testimony will be included in the record in its entirety, and we would ask you to try to summarize your written testimony in about 5

minutes. The little device you see in the center of the witness table, and likewise the little box up here has three lights. The green light lasts 4 minutes, the amber light lasts 1 minute, and the red light should not last very long. With that, we will begin with Dr. Mitchell.

**STATEMENT OF OLIVIA S. MITCHELL, PH.D., PROFESSOR OF INSURANCE AND RISK MANAGEMENT, EXECUTIVE DIRECTOR, PENSION RESEARCH COUNCIL, AND DIRECTOR, BOETTNER CENTER FOR PENSIONS AND RETIREMENT SECURITY, WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PENNSYLVANIA**

Dr. MITCHELL. Thank you very much, Mr. Chairman and Members of the Subcommittee. It is a pleasure to appear before you today. My name is Olivia Mitchell, and I teach insurance and risk management at the Wharton School at the University of Pennsylvania. The views that I am expressing today are my own. As we have heard, the Social Security system is running into trouble with a shortage of revenue to pay benefits within just a few short years. The 2001 Bipartisan Commission to Strengthen Social Security, on which I served, believed in that having two separate tiers would be the answer for a reformed Social Security program. Social adequacy would be provided by the first pillar of the traditional Social Security program, while individual equity would be the goal of the personal accounts component.

My testimony today focuses on two aspects of a personal retirement account, namely, first, administrative fees and charges; and, second, payout issues. What I will hope to persuade you of is that voluntary personal retirement accounts can and should be formulated so they offer participants some investment choice, while still remaining relatively inexpensive, they standardize disclosure regarding fees and charges so participants can understand what it is they are confronting, and require retirees to annuitize a portion of their retirement assets so the combined benefit payments of Social Security, the traditional piece, and the personal retirement accounts will keep them out of poverty.

Regarding administrative fees and charges, I would like to make four points. First of all, measuring pension expenses is a tricky business. I believe that a standardized format for reporting fees and charges would greatly enhance participants' ability to compare products and make informed decisions. Second, scale is very important. Large-scale plans, such as my university's retirement plan, and the Federal TSP we have heard about today, charge participants very low annual fees. Bigger is cheaper. Third, private retirement systems are not necessarily more expensive than Social Security. Rather, they generally offer many more services. I believe privately managed competitive fund providers can do better by taking advantage of modern technology. Fourth, the Commission on which I served proposed that investment choices in the personal accounts should be limited to a few indexed funds. We talked about a stock index fund, and a bond index fund. One of my personal favorites is the Treasury Inflation-Protected Securities (TIPS) Fund, which I think has a very crucial role in the retirement portfolio, and a life-cycle fund would also be a useful addition.

As you know from speaking to the prior panel, Employee Retirement Income Security Act (P.L. 93-406) requires a minimum of three funds in the private sector, so, some number between three and five seems reasonable to me. The Office of the Chief Actuary of Social Security estimated that the personal retirement account model we proposed on the Commission would be quite inexpensive, costing only about 0.3 percent of assets annually to manage.

The next issue to which I wish to turn is the issue of payouts; that is, how older participants in a personal account system would access their funds at retirement. The related question is what role annuities might play in such a payout scheme. Annuities are, of course, financial products that protect people from outliving their retirement assets. It is very important, I would note, that the money's worth of many of these life annuity products is very attractive in the United States and abroad. With regard to annuitization, my Commission proposed that partial annuitization should be required so that the yearly income received from the traditional Social Security pillar plus the joint annuity, if the person was married, would protect either spouse from falling below poverty in retirement. So, assets above what would be needed to achieve this poverty protection could be accessed as a lump sum. My written testimony discusses how retirees would learn about annuity products, who would sell them, and so forth. I will only mention a couple of points here. First of all, what annuity products would be offered and to whom? I believe Congress should set a default payout scheme such as a joint-survivor, ideally inflation-indexed, annuity which retirees would automatically get unless they opted for something else.

Second of all, I believe private insurers can offer the types of products that retirees want, but there needs to be enough oversight in this market to make sure that there is not cherry-picking of just the rich retirees, or perhaps just the people who are going to die soon, for the annuity market. I would not support having the Federal Government sell the mandatory annuities under the new system. A couple other points bear mention, which we hopefully will hear more about today: the government needs to think carefully about tax and transfer policy regarding these personal accounts; and, second of all, the Federal Government has a crucial role in making sure there are enough assets for annuity providers to purchase, so they can offer these inflation-indexed lifetime benefits.

In conclusion, I believe voluntary personal accounts can be designed to provide participants with investment choice while remaining inexpensive. They can build in incentives for competition among fund managers, and they can sensibly require retirees to annuitize a portion of their retirement assets. Thank you for your interest. I am happy to answer any questions.

[The prepared statement of Dr. Mitchell follows:]



**Statement of Olivia S. Mitchell, Ph.D.,<sup>1</sup> International Foundation of Employee Benefit Plans Professor and Professor of Insurance and Risk Management, Executive Director, Pension Research Council, and Director, Boettner Center for Pensions and Retirement Security, Wharton School, University of Pennsylvania, Philadelphia, Pennsylvania**

Mr. Chairman and members of the Subcommittee: Thank you for the opportunity to appear here today. My name is Olivia S. Mitchell, and I am a Professor of Insurance and Risk Management at The Wharton School at the University of Pennsylvania.

As you know, Social Security faces imminent insolvency, with payroll tax revenues threatening to fall below benefit payments within 6 years. The present system also contains many inequities and anomalous redistribution patterns, and it offers current workers a surprisingly low and very risky return.<sup>2</sup>

The bipartisan Commission to Strengthen Social Security (CSSS), on which I served in 2001, believed that offering *two separate tiers* under a reformed Social Security program, each with its own function, would improve the overall program's transparency and equity. Social adequacy was to be the principal objective of the traditional defined benefit piece, while individual equity was seen as the goal of a personal accounts component.

My testimony before this Subcommittee today focuses on two aspects that must be evaluated in designing a Personal Retirement Account element as part of a reformed Social Security: (1) administrative fees and charges, and (2) payout issues. My views derive from the research literature on administrative fees and payout issues, particularly regarding how Personal Retirement Accounts might be invested and how the funds at retirement might be deployed. The views I offer are my own and do not represent those of any institutions with which I am affiliated.

My conclusions are that the voluntary Personal Retirement Accounts (PRAs) should be formulated so that:

- They offer participants some investment choice while still being relatively inexpensive;
- They standardize disclosure regarding fees and charges so participants can understand and compare them;
- They require retirees to annuitize part of their retirement assets in their Personal Accounts, so that the combined benefit payments from Social Security will keep them out of poverty.

**Administrative Fees and Charges**

Experience with public and private pension plans the world over indicates wide disparity in reported administrative fees and charges across systems. Several lessons are worth highlighting:

- *Measuring pension expenses requires standardized reporting and disclosure standards.* Pension systems often structure their charges in bewildering ways. For instance, fees can be levied as flat commissions, a percent of contributions, or a percent of the fund's annual yield.<sup>3</sup> Such complexity makes it difficult for plan participants to compare fund performance. A sensible response, adopted by many Latin American pension supervisors, is to require disclosure using a standardized table for reporting charges. This has the effect of increasing the information available to participants and hence, making the market more competitive. A more problematic tactic adopted by the UK, for example, is to set a national fee cap. This may limit competition and reduce participants' focus on holding down costs.
- *Scale is important in keeping costs down.*<sup>4</sup> Larger money managers benefit from scale economies, centralized fund administration, and centralized collection of contributions. For example, in Australia, retail financial service providers charge three times more in pension fees and charges than do institutional managers of corporate pensions. While there is little agreement on the minimum size of a cost-effective pension, managers of large defined contribution plans such as the Federal Thrift Savings Plan which covers civil servants and mili-

<sup>1</sup>Olivia S. Mitchell is the International Foundation of Employee Benefit Plans Professor and Professor of Insurance and Risk Management; she is also Executive Director, Pension Research Council and Director, Boettner Center for Pensions and Retirement Security, all at The Wharton School of the University of Pennsylvania (3620 Locust Walk, St 3000 SH-DH, Philadelphia, PA 19104; email mitchelo@wharton.upenn.edu; T 215-898-0424). The views offered here are solely those of the author and do not represent those of any institutions with which she is affiliated.

<sup>2</sup>Cogan and Mitchell (2002).

<sup>3</sup>Mitchell (1998).

<sup>4</sup>See Mitchell (1998), Bateman and Mitchell (2004), and Whitehouse (2005).

tary employees, my University's retirement plan (TIAA-CREF and Vanguard), and others, charge pension participants annual fees between 0.1–0.4% of assets under management. These fees are well below what savers pay in typical Individual Retirement Accounts.

- *Private retirement systems might seem to be more costly than Social Security, but this is a misleading conclusion as they generally offer more and different services.* Some have suggested that the current U.S. Social Security system is one of the lowest-cost programs around. Nevertheless, Social Security does not provide the wide range of services provided by modern managers of asset-backed retirement accounts. For instance, the government program does not invest in the capital market, it holds no insurance-type reserves even though it offers disability and survivors' insurance, and it takes a very long time—more than a year—to post workers' contributions to their records.<sup>5</sup> By contrast, privately managed fund providers would and can do better by taking advantage of modern technology.

Taking these and other factors into account, I and other Commission members concluded that it would be reasonable *to establish personal accounts along the lines of the Federal Thrift Saving Plan*. Accordingly, and for a few years into the system, a central Governing Board would be charged with collecting contributions, managing records, and selecting private-sector managers who would invest participant assets via a competitive bidding process. This Board could either handle record-keeping and benefit payments itself, or these functions could be outsourced via a competitive process.

*We also proposed that investment choices in the personal accounts would be limited but diverse.* The options suggested include:

- a Government Securities Investment fund (mainly short-term U.S. Treasury securities);
- a Fixed Income Index Investment fund (tracking a U.S. bond market index);
- a Common Stock Index Investment fund (tracking the Standard & Poor's 500 Index of large-company stock);
- a Small Capitalization Stock Index Investment fund (tracking the Wilshire 4500 stock index); and
- an International Stock Index Investment fund; and
- a fund that invests in Government Treasury Inflation-Protected Securities.

At some later date, plan participants might be permitted to move their investments to licensed, supervised, private money managers offering an approved set of low-cost investment options. The benefit levels that might be expected from alternative investment approaches for Personal Retirement Accounts appear in Table 1, along with a comparison of current benefits, payable benefits, and scheduled benefits.

The Office of the Chief Actuary at Social Security estimated that the proposed CSSS approach *would be quite inexpensive, costing only about 0.3% of assets annually*.

**Table 1: Monthly Social Security Benefits Under Alternative Scenarios Projected to 2052**  
(CSSS Model 2 \$01)

<b>I. Lifetime low-wage earner*</b>	
<i>Today's benefit</i>	\$637
Projected Benefit With Personal Account:	
Low yield	867
Medium yield	1,050
High yield	1,090
Current Program Payable	713
Scheduled benefit	986
<b>II. Lifetime medium-wage earner*</b>	
<i>Today's benefit</i>	\$1,052
Projected Benefit With Personal Account:	
Low yield	1,204
Medium yield	1,525
High yield	1,595
Current Program Payable	1,179

<sup>5</sup> Mitchell (1998).

**Table 1: Monthly Social Security Benefits Under Alternative Scenarios Projected to 2052**  
(CSSS Model 2 \$01)—Continued

Scheduled benefit	1,628
<b>III. Lifetime maximum-wage earner*</b>	
<i>Today's benefit</i>	1,366
Projected Benefit With Personal Account:	
Low yield	1,565
Medium yield	1,907
High yield	1,983
Current Program Payable	1,557
Scheduled benefit under current law	2,151

\*These categories, developed by Social Security actuaries, are specified (in \$01) such that a lifetime "low" earner would have averaged approximately \$15,900 per year, whereas the medium earner averaged \$35,300 per annum and the high earner \$56,400.

Source: Cogan and Mitchell (2003)

### Payout Issues

When considering how to structure payouts from voluntary Personal Accounts under a reformed Social Security system, naturally the question arises as to whether and how access to the funds should be permitted. CSSS members agreed that pre-retirement access to the money should not be allowed to 'leak' out before retirement, as early consumption would likely increase the chances that the elderly would then have to rely on old-age antipoverty programs. Yet, as the Commission pointed out, "a clear appeal of personal retirement accounts is that they grant workers ownership over their own assets." After weighing competing arguments, we concluded that personal accounts should be preserved until the nationally-agreed on early retirement age, consistent with current Social Security policy which does not permit pre-retirement access to old-age benefits.

By contrast there is more discussion regarding appropriate designs for the pension decumulation process under Personal Accounts. This refers to the process by which older participants access their retirement assets, how they invest their money during retirement, and whether annuities—which are financial products designed to cover the risk of retirees outliving their assets—should play a central role. Regarding post-retirement fund management, my Commission recommended several methods of drawdown including phased withdrawals and annuities, as well as possibly lump sums.

To highlight the importance of longevity risk, Table 2 shows that a 65-year-old U.S. male can anticipate living to age 81, but he has almost a 20% chance of living to age 90 or beyond. A woman of the same age can expect to live to 85, but she has more than a 30% chance of living to age 90 or older (Table 2). In other words, people face substantial risk of outliving their life expectancy, implying substantial uncertainty regarding how long one must conserve and spend retirement assets, combined with a high probability of running out of money.

**Table 2: Remaining Life Expectancy and Survival at Age 65 (in 2000)**

	Remaining Life	Men	Women
Expectancy (years):		16.4	19.6
Probability of Surviving to Age:			
70		88%	92%
75		74	82
80		56	69
85		36	51
90		18	31
95		6	14
100		1	4

Source: Mitchell and McCarthy (2004)

A life-long annuity can help protect against this risk, by paying a premium to an insurer who then pools a number of people with similar longevity expectations. Though some have argued that such insured products seem expensive, my research shows that the "money's worth" (MW) of such life income products is rather substantial. The MW refers to the discounted cash flow of the lifetime payments received divided by the product premium. For example, Table 3 shows that U.S. purchasers of an immediate single-life annuity would expect back 93 cents on the dollar

from a life annuity; in exchange purchasers have the insurance value that they will never outline their lifetime benefit payments. The MW ratios are similar in Australia, Italy, and the UK.

**Table 3. Money's Worth of Single Premium Nominal Life Annuities for 65-Year-Olds: An International Comparison**(using country Treasury yield curves and annuitant life tables)

	Australia	Canada	Italy	UK	US
Men	0.986	1.014	0.958	0.966	0.927
Women	0.970	1.015	0.965	0.957	0.927

*Source:* Derived from Mitchell and McCarthy (2004)

These issues are complex and potentially politically delicate, since some workers will fail to accumulate much in their accounts over their worklives; also some retirees might anticipate relatively lower-than-average life expectancies, making forced annuitization seem punitive.

In balancing the various choices for payout design, the Commission concluded that *partial annuitization should be mandated* so that “the yearly income received from an individual’s Social Security benefit plus the joint annuity (if married) would protect either spouse from falling below the poverty line during retirement” (CSSL 2001). Any funds above those needed to buy the minimum annuity could be accessible as a lump sum and/or bequeathed at death. This approach has the dual benefit of both protecting the retiree from falling below the poverty line while still allowing some access to the funds accumulated in the Personal Retirement Account.

Remaining design issues include how retirees would learn about annuity products, who would sell them, and whether the private insurance market can do a good job meeting market demand. To date, relatively few consumers have purchased payout annuities, making it a bit difficult to forecast how the market will develop. Several key issues will have to be decided:

- *Which annuity products will be offered and to whom?*

Currently private insurers in the U.S. offer a wide and very complex array of annuity products, including immediate versus deferred benefit payments; fixed nominal payouts versus programs with escalating or variable payouts; and term certain versus other payment periods. Also annuities offered through company pensions are mandated to use unisex mortality tables whereas retail annuities do not.

A logical lesson from the behavioral finance literature is that it would be sensible to establish a “*default*” payout format such as a *joint and survivor inflation-linked or escalating life annuity*, which retirees would automatically receive unless they specifically opted for something else. As a case in point, retirees in the UK are required to annuitize their pension assets at age 75; in Germany, workers with assets in so-called Reister-pensions may take 20% of their accumulated assets in a lump sum, another 20% in a phased withdrawal format; but at age 85, the retiree must annuitize his balance and the benefit may not be lower than the periodic payment received before that age.

Of course, since many retirees are not accustomed to thinking about longevity risk, they would require financial education to help them clearly understand the costs and benefits of different ways to manage their Personal Retirement Account assets.

- *Which annuity providers will be allowed in the market, and how will they be regulated?*

Evidence from other countries adopting personal accounts indicates that private insurers can and do offer the types of products that retirees want. For instance, in Chile, middle and upper income workers generally prefer the annuity payout over a phased withdrawal approach to retirement drawdowns.

Nevertheless, there will likely have to be some governmental oversight over the annuity market. In Mexico, for instance, all insurers are required to bid on all retirees, and when issuing annuity bids, the companies may learn only a retiring worker’s age and sex (but not his identity, his health status, or his account balance). This reduces the chances of “cherry-picking” rich retirees or those anticipated to die soon.

Another issue has to do with whether unisex mortality tables would be required for the annuities. Doing so, of course, involves redistribution of wealth away from shorter-lived men and toward longer-lived women, which is already

true in the current Social Security System. Requiring joint and survivor benefits as a default would render this issue less important quantitatively.

- *What role, if any, would the federal government have?*

As an alternative to building up private annuity markets, some have suggested that the federal government might directly sell the mandatory annuities under the new system.<sup>6</sup> While this might hold down some costs, it can cause other problems. For example, there could be political interference associated with investing the annuity reserves—amounting to 15% of GDP at maturity—and it raises questions about whether the reserves could truly be saved, or whether they would be ‘spent’ akin to Social Security Trust Fund assets. Further, the government would then have responsibility for mortality and capital market risk, which would likely be incorrectly priced and managed.

One key role for the federal government in this context has to do with tax and transfer policy. For instance, pension and Individual Retirement Account assets are protected in bankruptcy but are divisible in divorce; whether the same treatment would be afforded PRA annuities and assets has yet to be determined. Conversely, annuity flows and lump sums are generally ‘counted’ when retirees apply for SSI and Medicaid benefits; payouts are taxed as income. Whether and how PRA assets and annuities are to be treated for tax and transfer purposes—as well as others (e.g. the estate tax vulnerability of the PRA assets if the worker or spouse dies) will take additional work to get it right.

Another role for the government is to enhance the range of investments available to insurers providing the products.<sup>7</sup> Many writers have noted the key role of *federal government provision of inflation-indexed bonds sufficient to meet market demand*. Expanding their supply would allow private insurers to offer the kinds of indexed annuity products that would give retirees better protection against inflation, which is a source of substantial retirement insecurity.

### Conclusions

My testimony has focused on the role of administrative fees and charges in a PRA type approach, and also on payout considerations after retirement. I conclude that voluntary Personal Retirement Accounts can be designed so as to provide participants with some investment choice while still being relatively inexpensive; they can build in incentives for competition among fund managers, including disclosure regarding fees and charges; and they can sensibly require retirees to annuitize part of their retirement assets in their Personal Accounts, so that the combined benefit payments will keep them out of poverty.

Thank you for your interest and I am happy to answer any questions you may have about my remarks.

### References

- Bateman, H. & O.S. Mitchell. “New Evidence on Pension Plan Design and Administrative Expenses.” *Journal of Pension Finance and Economics*. 2004: Vol 3(1): 63–76.
- Bodie, Z., B. Hammond, and O.S. Mitchell, eds. *Innovations in Financing Retirement*. Philadelphia, PA: University of Pennsylvania Press, 2002.
- Brown, J.R., O.S. Mitchell, J.M. Poterba. “The Role of Real Annuities and Indexed Bonds in an Individual Accounts Retirement Program.” In *Risk Aspects of Investment-Based Social Security Reform*. Eds. J. Campbell and M. Feldstein. 2000: 321–360.
- Brown, J., O.S. Mitchell, J. Poterba, and M. Warshawsky. *The Role of Annuity Markets in Financing Retirement*. MIT Press, 2001.
- Commission to Strengthen Social Security (CSSS), *Strengthening Social Security and Creating Personal Wealth for all Americans*, Final Report, Washington, D.C., December 2001.
- Cogan, J.F. & O.S. Mitchell. “Perspectives from the President’s Commission on Social Security Reform.” *Journal of Economic Perspectives*. 17(2). Spring 2003.
- Mitchell, O.S. “Administrative Costs of Public and Private Pension Plans”. In *Privatizing Social Security*, Ed. M. Feldstein. NBER. Chicago: University of Chicago Press, 1998: 403–456.
- Mitchell, Olivia S. & David McCarthy. “Annuities for an Ageing World”. In *Developing an Annuities Market in Europe*. Eds. E. Fornero & E. Luciano. Elgar, 2004: 19–68.

<sup>6</sup>NASI (2005).

<sup>7</sup>Bodie et al. (2002).

NASI *Uncharted Waters: Final Report*. [http://www.nasi.org/info-url\\_nocat2718/info-url\\_nocat\\_show.htm?doc\\_id=212573](http://www.nasi.org/info-url_nocat2718/info-url_nocat_show.htm?doc_id=212573)

Whitehouse, E. *Testimony Before the Subcommittee on Social Security of the House Committee on Ways and Means*, Washington, D.C. June 16, 2005.

---

Chairman MCCRERY. Thank you, Dr. Mitchell. Somehow the witnesses got scrambled on the table. I am going to follow my list as I introduced the witnesses, if that is okay. You will all get to speak. Our next witness is Mr. Purcell with the Congressional Research Service.

**STATEMENT OF PATRICK J. PURCELL, SPECIALIST IN SOCIAL LEGISLATION, DOMESTIC SOCIAL POLICY DIVISION, CONGRESSIONAL RESEARCH SERVICE**

Mr. PURCELL. Mr. Chairman, Congressman Levin, Members of the Subcommittee, my name is Patrick Purcell. I am a specialist in pension issues with the CRS. Thank you for inviting me to speak to you today about the TSP for Federal employees. The thrift plan, as you know, is a savings plan for Federal workers and members of the uniformed services. It was first authorized by the Congress with the ERISA 1986. The thrift plan provides Federal employees and members of the uniformed services with a tax-deferred savings vehicle similar to those provided by many employers in the private sector under section 401(k) of the Internal Revenue Code. The thrift plan was designed by Congress to be a key part of the retirement benefits for employees who are covered by the Federal Employees Retirement System, which covers all Federal workers hired since 1984.

Prior to enactment of the Social Security amendments 1983 (P.L. 98-21), Federal employees were not covered by Social Security. They were instead covered by a separate system, the Civil Service Retirement System (CSRS). The Social Security System needed additional cash contributions to remain solvent, and the 1983 amendments mandated coverage for civilian employees hired in 1984 and later. Congress recognized at that time that Social Security provided some of the same benefits for retirement and disability as the Civil Service Retirement System. Moreover, enrolling workers in both plans would have required payroll deductions equal to more than 13 percent of each employee's pay.

Consequently, Congress directed the development of a new Federal employee retirement system with Social Security as the cornerstone, and which would incorporate many features of the retirement plans typical among large employers in the private sector. The result of this effort was the Federal Employees Retirement System (FERS) which consists of three elements: Social Security, a traditional pension called the FERS Basic Retirement Annuity, and the TSP. The legislative history of the TSP indicates that in designing the system, Congress had the goals of incorporating Social Security into Federal employee retirement, providing a total benefit that was comparable to that under the old CSRS, and also keeping costs to the Federal Government approximately the same. Congress also for the first time allowed employees the opportunity to save for retirement on a tax-deferred basis through the TSP.

In the legislative history of the TSP, two things stand out. First, Congress chose then, and has maintained to this day, a system in which all of the thrift funds that invest in private sector securities are index funds. This was a carefully considered choice. As the House Committee report on the legislation stated, "The three funds authorized in the legislation are passively managed funds, not subject to political manipulation. A great deal of concern was raised about the possibility of political manipulation of large pools of thrift plan money. This legislation was designed to preclude that possibility." Likewise, the Senate Committee report on the legislation stated, "Another concern the Committee wrestled with was the potential for market manipulation through political pressure. The Committee specifically designed the plan to avoid this problem. The legislation provides for three investment funds that are essentially self-managed."

The second item that stands out in the legislative history is the strong interest that Congress showed in establishing the independence and authority of the Federal Thrift Investment Board. The legislation established the Thrift Board as an independent government agency, which is required by law to operate the plan solely in the interest of plan participants. The law charges the Thrift Board with responsibility for developing the investment policies of the thrift plan, and overseeing the management of the plan. The law authorizes the Board to appoint an Executive Director who runs the thrift plan on a day-to-day basis. Three members of the Board, including the Chairman, are appointed by the President. The President chooses a fourth member in consultation with the Speaker of the House and the House Minority leader, and a fifth member in consultation with the Senate Majority and Minority leaders. Members of the Board are subject to Senate confirmation and serve four-year terms. All members of the Board must have substantial experience in managing financial investments and pension plans.

The Federal Thrift Board receives no appropriations from Congress. Administrative expenses are paid through agency contributions forfeited by employees who leave Federal service before they have investigated and by charges against participant accounts. Congress conducts oversight of the TSP through the House Committee on government Reform and the Senate Committee on Homeland Security and governmental Affairs. The TSP is a key component of Federal employees' benefits. It is an efficient provider of retirement savings accounts to the Federal workforce that has achieved high participation rates and low administrative costs. This concludes my statement. I would be happy to answer any questions.

[The prepared statement of Mr. Purcell follows:]

**Statement of Patrick J. Purcell, Specialist in Social Legislation, Domestic Social Policy Division, Congressional Research Service**

Mr. Chairman and members of the subcommittee, my name is Patrick Purcell and I am a specialist in pension issues with the Congressional Research Service. Thank you for inviting me to speak to you today about the Thrift Savings Plan for federal employees.

The Thrift Savings Plan is a retirement savings plan for federal employees and members of the uniformed services. It was authorized by Congress in the *Federal Employees' Retirement System Act of 1986* (P.L. 99-335). The Thrift Plan provides

federal employees and members of the uniformed services with a tax-deferred savings vehicle similar to those provided by many employers in the private sector under section 401(k) of the Internal Revenue Code. The Thrift Plan was designed by Congress to be a key part of the retirement benefits for employees who are covered by the Federal Employees' Retirement System (FERS), which covers all federal employees hired on or after January 1, 1984.

#### *Origin of the Federal Employees' Retirement System*

Prior to enactment of the *Social Security Amendments of 1983* (P.L. 98–21), federal employees were not covered by Social Security. Federal employees were covered instead by the Civil Service Retirement System (CSRS). Because the Social Security system needed additional cash contributions to remain solvent, the 1983 amendments mandated coverage for civilian federal employees hired in 1984 or later.

Congress recognized, however, that Social Security provided some of the same benefits as CSRS. Moreover, enrolling federal workers in both plans would have required payroll deductions equal to more than 13% of employee pay. Consequently, Congress directed the development of a new federal employee retirement system with Social Security as the cornerstone and which would incorporate many features of the retirement programs typical among large employers in the private sector. The result of this effort was the Federal Employees' Retirement System, or FERS. FERS consists of three elements: (1) Social Security, (2) a traditional pension called the FERS basic retirement annuity, and (3) the Thrift Savings Plan.

The Thrift Plan is administered by an independent government agency, the Federal Retirement Thrift Investment Board, which is charged in statute with operating the Thrift Plan prudently and solely in the interest of the participants and their beneficiaries.<sup>1</sup> The assets of the Thrift Plan are maintained in the Thrift Savings Fund, which invests the assets in accordance with participant instructions in five investment funds authorized by Congress to be included in the plan.

Federal employees who participate in FERS, or its predecessor, the Civil Service Retirement System ("CSRS"), and members of the uniformed services are eligible to join the Thrift Plan immediately upon being hired. Generally, FERS employees are those employees hired on or after January 1, 1984, while CSRS employees are employees hired before January 1, 1984, who have not elected to convert to FERS. Each group has different rules that govern contribution rates.

As of March 31, 2005, there were 3.4 million participants in the Thrift Plan, with approximately 2.5 million contributing to the plan.<sup>2</sup> Among employees covered by FERS, 86% of those eligible to participate in the Thrift Plan do so. Among CSRS employees, about two-thirds participate. Assets of the plan totaled \$154 billion as of March 31. In terms of both assets and number of participants, the Thrift Savings Plan is the largest employer-sponsored retirement savings plan in the United States.

The Thrift Plan is legally a "defined contribution" plan. This means that it specifies how much an employee may contribute and how much the employing agency must contribute to each FERS employee's account. The employee owns the account and his or her benefit is equal to the account balance, which can be taken as a lump-sum, an annuity, or a series of periodic withdrawals.

#### *Contributions*

In 2005, FERS employees can contribute as much as 15 percent of basic pay on a tax-deferred basis, up to the \$14,000 maximum specified in section 402(g) of the Internal Revenue Code. Participants in FERS are entitled to receive employer matching contributions on the first five percent of pay that they contribute to the Thrift Plan.<sup>3</sup> Participants age 50 and older who are already contributing the maximum amount for which they are eligible are allowed to make supplemental tax-deferred "catch-up" contributions of up to \$4,000 in 2005.

In 2005, CSRS employees and members of the uniformed services can contribute up to ten percent of basic pay on a tax-deferred basis, subject to the \$14,000 maximum specified in the tax code. Members of the uniformed services also may contribute up to 100% of designated special pay, incentive pay, and bonuses to the Thrift Plan. Neither CSRS participants nor members of the uniformed services receive employer matching contributions because both CSRS and the military services provide pension benefits to career employees and career military personnel that are substantially larger as a percentage of career-average pay than the FERS basic retirement annuity.

<sup>1</sup> See 5 U.S.C. § 8472(h).

<sup>2</sup> See **Table 1** for complete Thrift Savings Plan enrollment statistics.

<sup>3</sup> The formula for agency matching contributions is specified in law at (5 U.S.C. § 8432(c)).



All FERS participants receive from their employing agencies an automatic contribution equal to one percent of basic pay.<sup>4</sup> Participants may also transfer funds from a traditional individual retirement accounts (IRA) or another eligible employer plan into the Thrift Plan.

#### *Investment Options*

As provided for in statute, Thrift Plan participants are offered five investment funds. Participants may allocate their contributions among any or all of the five investment funds, and they may reallocate their account balance among the five investment funds. The four funds that invest in private-sector securities are all index funds. These funds purchase securities in the same proportion as they are represented in an index of stocks or bonds, rather than through the decisions of an investment manager. Index funds have lower administrative costs than actively-managed funds, and because they purchase securities in the same proportion as they are represented in an index, there is little or no opportunity for the purchase of securities by the fund to be influenced by third parties who might benefit from having the fund invest in particular companies or sectors of the economy.

The five funds in the Thrift Plan are:

- the *Government Securities Investment Fund*, (the “G Fund”). This fund invests exclusively in U.S. Treasury Securities and other securities backed by the full faith and credit of the United States. Over the period from 1988 through 2004, the “G” fund earned an average annual rate of return of 6.6%.<sup>5</sup>
- the *Fixed Income Investment Fund*, (the “F Fund”). This fund invests in a bond index fund that tracks the performance of the Shearson Lehman Brothers Aggregate (SLBA) bond index. These securities consist of government bonds, corporate bonds, and mortgage-backed securities. From 1988 through 2004, the “F” fund earned an average annual rate of return of 7.7%.
- the *Common Stock Index Investment Fund* (the “C Fund”). This fund invests in stocks of the corporations that are represented in the Standard and Poor’s 500 index in the same proportion as they are represented in that index. During the period from 1988 through 2004, the “C” fund earned an average annual rate of return of 12.0%.
- the *Small Capitalization Stock Index Investment Fund* (the “S Fund”). This fund invests in the stocks of small and medium-sized companies incorporated in the United States. Stocks in this fund are held in the same proportion as they are represented in the Wilshire 4500 stock index. The average annual rate of return on the Wilshire 4500 from 1988 through 2004 was 12.7%.
- the *International Stock Index Investment Fund* (the “I Fund”). This fund invests in the common stocks of foreign corporations represented in the Morgan Stanley Capital Investment EAFE (Europe, Australia-Asia, Far East) index. The average annual rate of return on the EAFE Index from 1988 through 2004 was 6.1%

The Thrift Board has contracted with Barclays Global Investors to manage the index funds in which the F, C, S, and I Fund assets are invested. The contracts for each fund are open to competitive bids by qualified investment managers every three to five years.

#### *Participant Vesting*

Thrift Plan participants are immediately vested in all of their own contributions and investment earnings on those contributions.<sup>1</sup> Participants also are immediately vested in agency matching contributions made to their accounts and attributable earnings. In order to be vested in the agency automatic (1%) contributions, a FERS employee must have either 2 or 3 years of service as described in section 8432(g) of title 5 of the U.S. Code. FERS employees who are not vested and who separate from the federal government forfeit all agency automatic contributions and attributable earnings. Forfeited funds, consisting primarily of monies forfeited pursuant to 8432(g), totaled \$10,822,000 in 2004 and \$7,824,000 in 2003. By law, these funds are used to pay accrued administrative expenses of the Thrift Plan. If the forfeited funds are not sufficient to meet all administrative expenses, earnings on participant investments are then charged for administrative costs. In its most recent annual report, the plan reported administrative costs of six basis points, or six-hundredths

<sup>4</sup>Basic pay is defined in statute at (5 U.S.C. § 8401(4)).

<sup>5</sup>See **Table 2** for annual rates of return from 1988 through 2004.

<sup>6</sup>To “vest” in a benefit is to gain a legally enforceable right to receive it.

of 1%. Thus, the administrative expenses of the Thrift Plan are about 60 cents for each \$1,000 invested.<sup>7</sup>

#### *Participant Accounts*

The Thrift Plan maintains individual accounts for each participant. Participant accounts are credited with the participant's contributions, agency automatic and matching contributions, and charged with withdrawals. The value of the participant's account reflects the number of shares and the daily share prices of the funds in which it is invested. Administrative expenses are a component of the share price calculation. The benefit to which a participant is entitled is the participant's vested account. Thrift Plan participants can receive account-balance information and conduct transactions by automated telephone service or on the Thrift Plan's web site.<sup>8</sup>

#### *Participant Loans*

Participants may borrow from their accounts. There are two types of Plan loans: general purpose and residential. General purpose loans can be obtained for any purpose, with a repayment period from 1 to 5 years. Residential loans can be obtained for the purpose of purchasing a primary residence, with a repayment period from 1 to 15 years. Participant loans may only be taken from participant contributions and attributable earnings. The minimum loan amount is \$1,000. The interest rate for loans is the "G Fund" interest rate at the time the loan agreement is issued by the Plan's record keeper. The rate is fixed at this level for the life of each loan. Interest earned on loans is allocated to the participant account upon repayment. Participants whose loans are in default have until the end of the following calendar quarter to pay the overdue amount. If not repaid by that time, the loan plus accrued interest is treated as a taxable distribution to the plan participant, which may be subject to the 10% penalty on retirement plan distributions made before age 59½.

#### *Benefit Payments*

After leaving service, participants may elect benefit withdrawals in the form of a partial withdrawal or a full withdrawal as a single payment, a series of payments, or a life annuity. Participants may choose to combine any two, or all three, of the available withdrawal options. The Board has contracted with the Metropolitan Life Insurance Company to provide annuity products to Thrift Plan participants. The contract to issue Thrift Plan annuities is open to competitive bids every three to five years.

#### *The Federal Retirement Thrift Investment Board*

The Federal Retirement Thrift Investment Board was established by the FERS Act of 1986.<sup>9</sup> The Board is responsible for developing the investment policies of the Thrift Plan and overseeing the management of the plan, which is under the day-to-day direction of an Executive Director appointed by the Board.

Three of the five members of the Board—including the Chairman—are appointed by the President. The President chooses a fourth member of the Board in consultation with the Speaker of the House and the House Minority Leader and a fifth member in consultation with the Majority and Minority Leaders of the Senate. Members of the Board serve 4-year terms and all nominations are subject to Senate confirmation. The law requires that all nominees to the Board must be individuals with "substantial experience and expertise in the management of financial investments and pension benefit plans."<sup>10</sup>

The authorizing legislation that established the Thrift Board defines the Board's authority and responsibilities, and provides for substantial independence of the Board from political pressures.

#### *Authority*

The Thrift Board has the authority to:

- Appoint the Executive Director of the Thrift Plan;
- Remove the Executive Director for cause (This requires 4 votes of the 5-member Board.);
- Establish investment policies for the Thrift Plan;
- Instruct the Director to take whatever actions the Board deems appropriate to carry out the policies it establishes;
- Submit to the Congress legislative proposals relating to its responsibilities under federal law.

<sup>7</sup> See **Table 3** for the Thrift Savings Plan's assets, income, and expenses in 2004 and 2003.

<sup>8</sup> The URL of the Thrift Savings Plan web site is [www.tsp.gov](http://www.tsp.gov).

<sup>9</sup> See 5 U.S.C. § 8472.

<sup>10</sup> See 5 U.S.C. § 8472(d).

### *Independence*

Members of the Board are nominated by the President and confirmed by the Senate, but once confirmed they cannot be removed from their 4-year terms without good cause. The selection and nomination process are designed to assure that Members of the Board are individuals who are supported by the President and Congress. They serve in times of good behavior, rather than at the pleasure of the President or Congress, assuring that they can carry out the responsibilities of their positions without of removal from office. The Federal Retirement Thrift Investment Board receives no appropriations from Congress. Administrative expenses are paid through agency-automatic contributions forfeited by employees who leave federal service before they have vested and charges against participant accounts.

### *Responsibility*

The law requires that the members of the Board shall discharge their responsibilities solely in the interest of participants and beneficiaries. In practice, this means that the investment policies and management practices of the fund are evaluated by the Board exclusively in reference to the efficient and prudent management of the Fund's assets. This exclusive responsibility serves to further insulate the Board from pressures to adopt investment policies or management practices that might not be in the long-term interest of preserving and increasing the security and investment performance of the Fund's assets.

### *Oversight*

To assure that the Members of the Thrift Board remain aware of the interests and concerns of Thrift Plan participants and beneficiaries, the authorizing legislation established the Employee Thrift Advisory Council. This 14-member council is appointed by the Chairman of the Thrift Board and must include representatives of federal employee and Postal Service labor organizations, managerial employees, supervisory employees, female employees, senior executives, and annuitants.

All fiduciaries of the plan, including members of the Thrift Board are required by law to be bonded.<sup>11</sup> The Secretary of Labor is authorized by law to investigate any suspected breach of duty by a fiduciary of the plan. The financial statements of the Thrift Board are audited regularly by an independent accounting firm. Congressional oversight of the Thrift Plan is performed by the House Committee on Government Reform and the Senate Committee on Homeland Security and Governmental Affairs.

### *Conclusion*

The Thrift Savings Plan is an efficient provider of retirement savings accounts to the federal workforce. It has achieved high participation rates and low administrative costs. The Thrift Plan is a key component of federal employees' retirement benefits. This is especially true for workers in the middle and upper ranges of the federal pay scale who would be unlikely to achieve adequate retirement income from just Social Security, the FERS basic annuity, and the government's automatic contribution of 1% of pay to the plan. Later this year, the Thrift Plan will begin to offer life-cycle funds that will allow employees to have their investments re-balanced with a greater weight toward corporate and government bonds as they approach retirement age, thus protecting their accumulated assets from a sudden downturn in the stock market just as they are about to retire.

This concludes my testimony and I would be happy to answer any questions that members of the subcommittee might have.

**Table 1. Thrift Savings Fund Statistics**

<b>Fund balances, in millions</b>	<b>March 2005</b>	<b>February 2005</b>	<b>January 2005</b>
"G" Fund	61,060 40%	60,066 39%	59,760 40%
"F" Fund	10,079 7%	10,222 7%	10,279 7%
"C" Fund	64,368 41%	65,589 42%	64,163 42%
"S" Fund	9,847 6%	10,028 7%	9,681 6%

<sup>11</sup> A "fiduciary" is a person in a position of trust or confidence with regard to the property of another. A "bond" is form of insurance against the potential malfeasance of a plan fiduciary.

Table 1. Thrift Savings Fund Statistics—Continued

Fund balances, in millions	March 2005	February 2005	January 2005
“T” Fund	8,678 6%	8,325 5%	7,451 5%
<b>Total</b>	\$154,032 100%	154,230 100%	151,334 100%
Twelve-month returns			
“G” Fund	4.45%	4.36%	4.38%
“F” Fund	1.17%	2.36%	4.07%
“C” Fund	6.76%	6.99%	6.24%
“S” Fund	7.95%	10.42%	10.14%
“T” Fund	14.96%	18.64%	16.22%
<b>Participants (thousands)</b>			
FERS, contrib- uting	1,539	1,543	1,553
FERS, agency 1% only	243	237	234
FERS partici- pation rate	86.4%	86.7%	86.9%
FERS, without agency 1%	71	63	55
Total FERS with con- tributions	1,853	1,843	1,842
CSRS contrib- uting	449	454	465
Uniformed services	476	478	458
Participants, not contrib- uting	661	663	657
Total TSP par- ticipants	3,439	3,438	3,422
<b>Loans out- standing</b>			
Number	859,386	872,240	883,357
Amount (mil- lions of \$)	\$4,908	\$4,969	\$5,033

Source: Federal Retirement Thrift Investment Board.

Table 2. Annual Rates of Return for Thrift Savings Plan Funds

Year	G Fund	C Fund	F Fund	S Fund	I Fund
1988	8.8%	11.8%	3.6%	20.5%	26.1%
1989	8.8%	31.0%	13.9%	23.9%	10.0%
1990	8.9%	-3.2%	8.0%	-13.6%	-23.6%
1991	8.1%	30.8%	15.7%	43.5%	12.2%
1992	7.2%	7.7%	7.2%	11.9%	-12.2%
1993	6.1%	10.1%	9.5%	14.6%	32.7%
1994	7.2%	1.3%	-3.0%	-2.7%	7.8%
1995	7.0%	37.4%	18.3%	33.5%	11.3%
1996	6.8%	22.8%	3.7%	17.2%	6.1%
1997	6.8%	33.2%	9.6%	25.7%	1.5%
1998	5.7%	28.4%	8.7%	8.6%	20.1%
1999	6.0%	21.0%	-0.8%	35.5%	26.7%
2000	6.4%	-9.1%	11.7%	-15.8%	-14.2%
2001	5.4%	-11.9%	8.6%	-2.2%	-15.4%
2002	5.0%	-22.1%	10.3%	-18.1%	-16.0%
2003	4.1%	28.5%	4.1%	42.9%	37.9%
2004	4.3%	10.8%	4.3%	18.0%	20.0%
<b>1988-2004</b>	<b>6.6%</b>	<b>12.0%</b>	<b>7.7%</b>	<b>12.7%</b>	<b>6.1%</b>

Source: www.tsp.gov, www.wilshire.com, www.msci.com.

Note: Rates of return for the C, G, and F funds are shown net of TSP expenses.

Table 3. Financial Statements of the Thrift Savings Fund Statements of Net Assets Available for Benefits as of December 31, 2004 and 2003 (In thousands)

	2004	2003
<b>ASSETS:</b>		
Investments, at fair value:		
U.S. Government Securities Investment Fund	\$56,670,880	\$51,121,034
Barclays U.S. Debt Index Fund	9,732,943	10,071,287
Barclays Equity Index Fund	63,218,611	54,303,506
Barclays Extended Market Index Fund	9,644,143	5,622,444
Barclays EAFE Index Fund	7,021,069	2,211,875
Participant loans	5,105,715	5,130,170
	151,393,361	128,460,316
<b>Total investments</b>		

**Table 3. Financial Statements of the Thrift Savings Fund Statements of Net Assets Available for Benefits as of December 31, 2004 and 2003 (In thousands)—Continued**

	2004	2003
Receivables:		
Employer contributions	166,045	151,497
Participant contributions	507,034	446,574
Total receivables	673,079	598,071
Fixed assets, total:	41,839	39,715
Other assets	5,460	11,236
<b>Total assets</b>	<b>152,113,739</b>	<b>129,109,338</b>
<b>LIABILITIES:</b>		
Total liabilities	99,984	179,216
Funds restricted for the purchase of		
Fiduciary Insurance	– 4,829	– 4,978
<b>Net Assets Available for Benefits</b>	<b>\$152,008,926</b>	<b>\$128,925,144</b>
<b>ADDITIONS:</b>		
Investment income (loss):		
U.S. Government Securities Investment Fund	\$2,346,104	\$2,074,004
Net appreciation (depreciation) in fair value		
of Barclays funds:		
Barclays U.S. Debt Index Fund	408,397	455,956
Barclays Equity Index Fund	6,115,843	11,316,657
Barclays Extended Market Index Fund	1,249,934	914,990
Barclays EAFE Index Fund	870,403	358,102
Interest income on participant loans	237,684	222,422

**Table 3. Financial Statements of the Thrift Savings Fund Statements of Net Assets Available for Benefits as of December 31, 2004 and 2003 (In thousands)—Continued**

	2004	2003
Asset Manager rebates	1,778	1,616
Less investment expenses	– 4,503	– 3,708
Net investment income (loss)	11,225,640	15,340,039
Contributions:		
Participant	11,980,077	10,366,123
Employer	4,238,199	3,887,260
Total contributions	16,218,276	14,253,383
Total additions	27,443,916	29,593,422
<b>DEDUCTIONS:</b>		
Benefits paid to participants	4,110,891	2,774,685
Administrative expenses	91,896	75,038
Participant loans declared taxable distributions	157,496	130,559
Total deductions	4,360,283	2,980,282
Change in funds restricted for the purchase of		
Fiduciary Insurance	149	375
Net increase	23,083,782	26,613,515
<b>NET ASSETS AVAILABLE FOR BENEFITS:</b>		
<b>Beginning of year</b>	128,925,144	102,311,629
<b>End of year</b>	\$152,008,926	\$128,925,144

**Source:** Financial statements of the Thrift Savings Plan [<http://www.tsp.gov/forms/financial-stmt.pdf>].

Chairman MCCRERY. Just to advise the witnesses of the order that I called, Mr. Pollock will be next, then Ms. Entmacher, Mr. Cavanaugh, and Ms. Reno. Mr. Pollock, you may proceed.

**STATEMENT OF ALEX J. POLLOCK, RESIDENT FELLOW,  
AMERICAN ENTERPRISE INSTITUTE**

Mr. POLLOCK. Thank you, Mr. Chairman, Ranking Member Levin, Members of the Subcommittee, I would like to start by taking a minute to look back into the insight of Congressman J.J. Pickle, who died this last Saturday and who was, of course, a Chairman of this Subcommittee, and who knew that in order to protect Social Security, you had to change it. Chairman Pickle told the Advisory Council on Social Security in 1995, "The public knows that change in the Social Security program is necessary, and lack of action will be seen as failure in leadership, not as protecting interests."

Mr. Chairman, I think Chairman Pickle was absolutely right in 1995, and his words are absolutely right today. The public knows change has to happen, and the public knows something else: That in exchange for the money that they send in to Social Security, as Congressman Lewis was saying a minute ago, they would like to have an individual right where there actually exists an obligation for their retirement savings. Congressman Becerra made a similar point: there should be such an obligation. However, under the current Social Security program with the current trust fund, as we call it, the Supreme Court has made it clear there is no such obligation to any individual, again, as Congressman Lewis so rightly said. Now, we could create a clear and unquestionable obligation of the United States to the citizens individually. There is an instrument readily available to do that. It is called a United States Treasury Bond. That is an inviolable contract obligation.

This brings us to linking Social Security to the philosophical ideal of ownership. Widely dispersed ownership throughout the society is deeply embedded, and one of the best elements of the American traditional political philosophy. It goes back to John Locke, the philosophical father of representative democracy, to the First Continental Congress, and among American Presidents, particularly to Jefferson and Lincoln. We have all kinds of programs in this country, and rightly so, to promote ownership in the form of home ownership. Ownership of retirement savings carries out the same principles and would carry out the same philosophy.

Now, suppose there were a way to make at least part of Social Security a truly inviolable ownership obligation for the individual, which resulted in no cash shortfall to the Treasury, no investment risk to households, no default risk, no inflation risk, no increase in total government debt, and, moreover, it were a voluntary program where individuals had the choice to participate or not. I think everybody should support such a program. Who could be against it? I certainly think that the vast majority of the Americans who worry about what their individual rights in Social Security are would support this program.



Now, there is, in fact, a way to do this. I call it your “personal lockbox.” Here is how it would work. Consider the current way we use the Old-Age and Survivors Insurance (OASI) surplus, which was about \$145 billion in 2004 and is expected to rise to \$200 billion annually, or so, during the next decade. Americans pay their Social Security taxes. As we know, the Treasury actually gets the cash, and Treasury issues a bond to the trust fund. As we also know, this is an odd kind of bond. It is debt of the government to itself. It is an “I-owe-me,” as somebody has said. As we all know, economically and financially, the size of the trust fund, whether it be large or whether it be zero, has absolutely no, zero, economic effect on the finances of the United States. So, now we need to make only one simple change: Americans pay the same Social Security taxes as now, Treasury gets the same cash they get now, the Treasury issues a bond, just as it does now, but that bond goes to your individual account, your personal lockbox.

It is now an IOU, it is a real bond, it is a real asset for American families. It has become an inviolable contract. It can be inherited, and since it is a Treasury bond, it has no default risk. If we make it a TIPS, it will also have no inflation risk. Mr. Chairman, as we know, inflation is the greatest risk to retirement savings. So, putting TIPS into these personal lockboxes, I think, takes a huge step forward in making Social Security what I believe most Americans think it should be. It will also be an exceptionally low-cost, efficient, purely book entry system, very cheap to operate.

There are many details in my written testimony. I would only say if we make this a voluntary option available to the American people to get TIPS in their own accounts in exchange for the surpluses, it will look to them just like payroll deductions to buy savings bonds. We will have very little educational effort, everyone will understand this immediately, and I would be willing, Mr. Chairman, to bet a large amount of my personal money that a large majority of Americans would volunteer for this program. Indeed, how could anyone oppose giving them this choice? Mr. Chairman, thank you very much for the opportunity to be here today.

[The prepared statement of Mr. Pollock follows:]

**Statement of Alex J. Pollock, Resident Fellow, American Enterprise  
Institute Summary Statement**

Good morning, Mr. Chairman, Ranking Member Levin, and members of the Subcommittee. Thank you for the opportunity to testify today. I am Alex Pollock, a Resident Fellow at the American Enterprise Institute, and these are my personal views and recommendations.

Linking ownership of property to liberty in a free society is deeply embedded in the American political philosophy, going back to the ideas of John Locke and the First Continental Congress. Personal Social Security accounts as vehicles for the expansion of ownership of retirement assets are very much in keeping with this American tradition.

By creating “personal lock boxes” invested in Treasury inflation-indexed bonds, Congress can make such accounts a reality in a highly efficient, low cost, low risk, sensible and easily understandable way. It would also make social security at least in part what most people think it should be: a retirement account building up your own personal savings.

What is happening today, as we all know, is that some social security contributions are diverted into general government expenditures, evidenced by debt of the government to itself, or “I owe me’s,” in the social security trust fund. In contrast, without diverting taxes or cash from the Treasury, personal accounts—“your personal lock box”—can be created with real Treasury bonds held by the public.

Consider how the “investment” of the social security surplus currently works: Social Security taxes are collected by the Internal Revenue Service and deposited in the general fund at the Treasury Department, where they are spent on benefits but also on other federal programs. In exchange for these “invested” Social Security funds, the Treasury issues bonds to the Social Security trust fund. The bonds represent government liabilities to itself (“I owe me’s”), rather than real obligations to the public.

I suggest creating personal accounts with the annual social security surplus which protects it for retirement savings, without diverting cash from payroll taxes. This could be done by changing the current structure in one key respect: the Treasury would issue bonds directly to personal accounts, bypassing the confusing role of the trust fund, thereby creating “your personal lock box” of explicit government obligations.

The personal accounts would be created by putting Treasury securities in them, not cash. The current trust fund is an unnecessary and confusing. The citizens and the U.S. Treasury are the only actual principals involved. Personal lock boxes would protect the social security surplus, make the accounting much clearer and more honest, and make the citizens direct owners of top quality retirement assets.

There are perfect Treasury bonds for these accounts: Treasury Inflation Protected Securities (TIPS). Inflation poses the largest threat to retirement savings, and these default-free instruments also fully protect against that threat, thereby minimizing risk.

Moreover, because these bonds operate on a book-entry basis, the program would have very low operating and administrative costs.

According to the 2005 Annual Report of the Social Security Trustees, the OASI program (excluding the Disability Insurance program) ran a 2004 surplus of \$145 billion. This represented over 30% of total OASI contributions of \$473 billion. The 10-year intermediate case projection is for an aggregate OASI surplus of over \$2 trillion. Instead of continuing the “I owe me” approach with this surplus, personal lock boxes could turn this \$2 trillion into real assets of American households, free of both default and inflation risk.

The Trustees’ intermediate projection suggests that the OASI trust fund would stay approximately level, and the going-forward surpluses thus protected, if about half of the employee’s social security tax were converted to TIPS in personal lock boxes each year. This would mean that Americans would receive real assets equal to 2.65 % (half of 5.3 %) of income subject to social security tax each year. For a household with median 2003 income of \$43,000, this would result in an initial year personal lock box account of over \$1,100.

I recommend the personal lock box as a purely voluntary program; individuals could elect either to remain in the current program or to receive TIPS in their personal accounts instead of future benefit payments of equal economic value. After a certain restricted period (I suggest five years), individuals could choose to reinvest their assets in other financial instruments, although I believe a many would simply stay with the TIPS “default option.” Ownership through personal accounts would also allow for account holders to bequeath their assets to future generations.

Think how much more meaningful direct ownership of these Treasury bonds in a personal account—in “your personal lock box”—would be for American individuals and families than the obscure operations of the current trust fund which few understand.

In my opinion, TIPS would be an extremely popular alternative—simple, easy to understand, and attractive. By analogy to the federal employees’ thrift plan, it could be thought of as “a G-Fund for everybody.”

The personal lock box would result in greater and more widely distributed ownership of financial assets among American households. It would provide assets with no default risk and no inflation risk, with the ability to pass them on to future generations. It would establish a stronger and more honest financial relationship between government and citizens. Treasury securities are in fact inviolable contracts, in contrast to off-balance sheet future political formulas.

I believe a large majority of Americans would prefer to accumulate inflation-protected retirement assets they actually own. They should be given this choice.

“Your Personal Lock Box”:

#### *A New Approach to Personal Social Security Accounts*

Mr. Chairman, Ranking Member Levin, and Members of the Subcommittee, thank you for the opportunity to testify today. I am Alex Pollock, a Resident Fellow at the

American Enterprise Institute, and these are my personal views and recommendations.

By transforming Social Security, at least in part, to a program of greater personal property for the average American, voluntary personal accounts would be a key structural reform.

But most current proposals for personal accounts also have serious disadvantages: they are complicated, to many people they are confusing and they require diverting a portion of payroll taxes away from the U.S. Treasury. How can there be effective management for millions of small accounts? Isn't the stock market too risky? Won't many people be confused by being forced to make choices they do not understand? Who can be sure the benefits are worth the costs and risks?

There is, however, a better way to launch Social Security reform using private accounts and inflation-indexed Treasury bonds (or "TIPS"), which will deliver all of the benefits of personal accounts with none of the costs or risks cited by their opponents.

I propose creating personal accounts, or "Your Personal Lock Box," with an extremely simple and clear financial structure, without diverting any payroll tax receipts away from the U.S. Treasury, and with low cost and efficient operations. The results will be greater ownership of risk-free assets throughout American households, ability for inheritance, clear links between one's own efforts and retirement savings, and complete clarity in the dealings between the government and the citizens. The transition could begin promptly.

The essential proposal is this: Social Security tax payments by individuals and employers, and Social Security tax receipts by the government would remain the same as they are now. Treasury would have the same cash receipts from Social Security taxes as it does now. But in exchange for the going-forward investment of OASI surplus contributions, Treasury would not issue bonds to the Social Security trust fund. Instead it would issue bonds—specifically, inflation-indexed bonds or "TIPS"—directly to the personal accounts of the individual citizens themselves, which would become in effect their own personal lock boxes. These accounts would not receive cash but would automatically receive the safest possible investment for retirement savings.

This is proposed as a *voluntary* alternative covering the portion of Social Security taxes which represents mandatory savings of OASI surpluses. Everyone would be given the choice to participate in the proposed personal accounts or stay in the current Social Security program. I believe that a large majority would choose the personal accounts if they are designed as recommended, but this should be a purely voluntary option.

This financial structure transparently shows the real transaction which is taking place between the two real principals involved: the American citizen and the U.S. Treasury Department. It cuts out the unnecessary and confusing role of the Social Security trust fund, which in fact is debt of the government to itself, or an "I owe me."

The government's total obligations would not increase. Some Treasury debt would shift from being owned by the intra-governmental trust fund to being owned directly by the citizens themselves in their own personal lock box accounts. The bonds in the personal accounts would represent an increase in Treasury debt owned by the public, but would be issued, like bonds now sent to the government's trust fund, as automatic private placements.

### **Simplicity**

The simplicity of the proposed approach would remove from the current political debates many distracting issues, such as whether we could afford the transition costs, whether personal accounts would be too risky, whether Wall Street would reap a bonanza, and whether operating costs would be too high. It would make unnecessary the proposed delay in implementation until 2009.

It would also remove a central objection made by the opponents of personal accounts: that Social Security must be a moral imperative, an inviolable promise and part of the social contract. Nothing could make Social Security more imperative, inviolable, and a contract than to turn it into a U.S. Treasury bond. Indeed, the only advantage which might be argued for the current Social Security structure over the proposed personal accounts is that the current structure leaves open the possibility for the government to renege on its promises and reduce benefits. This is presumably not an argument that opponents of personal accounts will wish to emphasize.

How much of the current structure should be replaced by the proposed personal accounts? The answer reflects the fact that Social Security has two components: first, a mandatory savings program for retirement and old age, applicable to citizens

of all levels of income; and second, a welfare or safety net program providing a minimum retirement income and disability insurance.

The second component by definition requires commingling of funds and should remain as it is. This would include the disability portion of Social Security and the provision of a minimum retirement income for low income households.

The proposed personal accounts apply to the first or mandatory savings component: which is what most Americans think their Social Security payments should be. I suggest that half of the employee's share of Social Security taxes, which represents mandatory saving of approximately the OASI annual surplus, should have available this personal account option.

The simplicity of the proposed change to protect the surplus is easy to see by reviewing the current structure of Social Security and contrasting it with the proposal.

#### **Current Structure for Social Security Surpluses**

The current Social Security structure handles surpluses with the following process:

A. Cash from the citizen, both directly from wages and indirectly as employer contributions which could otherwise have been wages, is sent to the government as Social Security taxes.

B. Social Security cash goes to the U.S. Treasury

C. Treasury issues a Treasury debt obligation to the Social Security program. It is part of the total Treasury debt outstanding, but is an "I owe me."

#### **A New Structure for Personal Accounts**

In the proposed structure, there would be no diversion of cash from the Treasury. Social Security payroll taxes paid to the government and cash received by the Treasury would stay the same as under the current structure. If voluntarily chosen by the citizen, the portion of these taxes representing the OASI annual surplus would be earmarked for personal lock box accounts. However, these accounts would not receive cash, but automatically receive an appropriate Treasury inflation-indexed security.

The surplus investment function would thus work as follows:

A. Social Security taxes would be sent to the government, as they are now.

B. Treasury's cash receipts would be the same as they are now. There would be no cash shortfall.

C. Treasury would continue to issue a Treasury debt obligation, *but to the citizen's personal account, not to the trust fund—thereby creating "your personal lock box."*

That is all. Thus the citizen would own a risk-free investment very well suited for retirement savings: an inflation-indexed Treasury security. Treasury debt owned by the public in personal accounts has increased, but debt owned by the trust fund has decreased. Treasury owes the citizen explicitly and clearly, rather than confusingly owing the government itself.

Since the savings are now in the form of a directly owned, actual Treasury bond instead of future Social Security benefits, there must of necessity be an equivalent reduction in future benefits to offset the acquired Treasury security. The trust fund does not receive Treasury bonds but by the same taken has reduced future benefit liabilities. For the citizen, the replacement of future benefits with actual assets of course applies only on a going-forward basis, as the personal accounts grow. All benefits earned by past Social Security taxes, before the private accounts transition, would remain unchanged.

The proposed structure is quite similar to a historically tried and true long-term savings program: payroll deduction for the purchase of U.S. savings bonds. It is also similar to a very popular option under the Thrift Savings Plan for federal government employees: the "G Fund," which invests solely in U.S. Treasury obligations.

Such analogies, as well as the basic simplicity of the structure, would make it easy for the public to understand. Would most people choose to create their own portfolio of Treasury inflation-indexed bonds rather than hoping for future payments from off-balance-sheet political formulas? I think they would—by a large majority.

#### **Relation to Future Benefits**

If the economic value of the bonds acquired in the personal accounts is exactly equal to the economic value of the reduction in future off-balance-sheet future benefit promises, we would have created the many advantages of ownership, but the aggregate Social Security fiscal deficit would remain unchanged. However, this trade-off could be given a progressive structure, analogous to recent proposals for progressive changes to Social Security indexation formulas, for high-income households.

In other words, for the majority of households the TIPS exchange ratio would be 1 to 1, but for high income households it could be greater than 1 to 1. Since many of these households believe that in any case, their Social Security taxes will inevitably increase or their future benefits be reduced, or both, the trade in exchange for achieving personal accounts could be viewed as advantageous. The transition to personal accounts would then reduce the Social Security deficit, in addition to its other attractions.

### **The Specific Treasury Bond**

The perfect candidate for the Treasury obligations to be issued to the personal Social Security accounts is clear: Treasury Inflation Protected Securities (TIPS). TIPS by definition preserve purchasing power against inflation, the single greatest risk and an essential consideration for retirement savings.

The TIPS would be issued in automatic private placements for each personal account. Because all the TIPS involved will be book-entry securities in fully automated form, small accounts and small amounts could be easily handled, and operating costs will be low.

Suggestions for how the details of this would work follow. Details could obviously vary around the essential structure.

The TIPS should have maturities based on the individual's expected retirement date. For example, a twenty-five-year-old with an expected retirement age of sixty-five might in the first instance receive a forty-year TIPS. Note that it is proposed to consider creating long-term TIPS to match the needs of retirement savings. All interest and inflation adjustments should simply accrue, as with typical savings bonds, so there is no problem of investing small amounts of cash. Laddering maturities as discussed below would result in a sensible pattern of cash flow during retirement.

The average real return of government bonds (i.e. the yield net of inflation) in the long term is approximately 3 percent. The long-term TIPS to be privately placed in the personal accounts with a restricted period could have a real yield of about this same 3 percent. In an average inflation of 2 or 3 percent, for example, this would result in a compound annual return of 5 or 6 percent, respectively. A 3 percent real yield would match the real 3-percent discount rate often used in calculations of the value of future Social Security benefits.

For ownership to be effective, the TIPS received in the personal accounts must be negotiable securities. However, it would make sense to have a period after each private placement during which sale would be restricted. After that, the citizen would be entirely free to sell in order to make other eligible investments, if desired, provided of course that all proceeds and investments must stay in the retirement account until qualified for withdrawal.

The appropriate length of the restricted period before the privately placed TIPS would become negotiable must be defined. A starting suggestion would be five years, to insure a smooth transition, while also allowing the future addition of private asset categories.

The maturities of the TIPS should be based on expected retirement age but should not all mature at that date, which would cause a difficult decision point and large reinvestment risk. The idea of buying an annuity upon retirement does not address this problem, since if at that time interest rates are low, annuities will be unattractive to purchase—not to mention the need to address the credit risk of the annuity writer. A preferable approach would be to automatically ladder the maturities of the TIPS in the personal accounts to spread cash receipts from maturing bonds over the retirement years. Recall in this context that the safety net component of Social Security would also continue to function.

Individuals who choose to continue working past retirement age would continue to accumulate assets in their personal accounts. This would provide an incentive to reduce the extended period of retirement which is a central cause of Social Security's fiscal deficit without having to mandate changes in retirement age that would naturally be inappropriate in many individual cases.

In sum, the personal lock box accounts would represent a voluntary way to hold mandatory savings, while explicitly protecting the social security surpluses. Continuing to hold the TIPS past their restricted period would also be voluntary.

But *no* investment decisions or risks would be forced upon the citizen. Especially considering those who might feel confused or intimidated, no action would be required to have a very sensible and safe investment, with zero credit risk and guaranteed inflation protection, very suitable for retirement savings, automatically provided. This means that there is a robust "default case," an important element in a system of choices.

A safe prediction is that a significant proportion of these securities would never be sold, but would be held to maturity. There would be no rush and no pressure on the individual to have to do anything, unlike the case of having to invest cash. In addition, the restricted period should comfort any observers who might fear the possibility, however unlikely, of a large initial outflow of TIPS into the market.

#### **Benefits for an Ordinary Couple**

Suppose an ordinary couple signed up for the personal account option when they were both twenty-five years old, with a household income of \$50,000 per year. What might their personal account retirement assets look like at age sixty-five, assuming the "default case" of simply holding their TIPS?

As an example, assume the real yield on TIPS is 3 percent, average inflation of 2.5 percent, real wage increases of 1.5 percent, and half the Social Security tax represents mandatory savings devoted to personal accounts. At age sixty-five they would own investments totaling over \$800,000. If they worked to age seventy in line with their greater expected longevity and health, the personal account investments would total \$1.15 million.

Now suppose two-thirds of the Social Security tax represents mandatory savings which generate TIPS for the personal account. At sixty-five, the investments would be more than \$1 million; and at age seventy, more than \$1.5 million.

These would be real assets, really owned by ordinary Americans.

#### **Conclusion**

The proposed approach would lead to personal Social Security accounts as a key transition and structural reform. It addresses all of the objections to private accounts, as follows:

1. There would be no cash shortfall to the Treasury.
2. There would be no increase in the total national obligations. Treasury debt owned by the public would increase, but Treasury debt owned by the trust fund would decrease. Off-balance-sheet future benefit liabilities would also decrease. If the suggested progressive structure were adopted, future liabilities would decrease by more than the value of the TIPS issued, thus reducing the Social Security deficit.
3. There would be no need to market more Treasury debt—the bonds involved would automatically be privately placed in the personal lock box accounts.
4. No difficult choices would be imposed on individuals—if they do nothing, a very safe and appropriate retirement investment is automatically provided. The default case is robust.
5. There is no pressure to take risk or "roll the dice." *TIPS are the exact opposite of rolling the dice.* In particular, they directly address the biggest risk to retirement savings, namely inflation.
6. The obligation of the government for social security surpluses is made truly inviolable by becoming an explicit Treasury bond.
7. The use of TIPS would allow a very low cost, efficient book entry system.
8. With investments automatically provided, there is no windfall for Wall Street, and small accounts can be handled efficiently.
9. Appropriate long-term investments matched to retirement needs are automatically provided.
10. The proposal would allow prompt implementation.

Moreover, the idea is simple and easy to understand. As a voluntary alternative, I believe having "your personal lock box" would be readily chosen by a large majority of Americans.

---

Chairman MCCRERY. Thank you, Mr. Pollock. Ms. Entmacher.

#### **STATEMENT OF JOAN ENTMACHER, VICE PRESIDENT AND DIRECTOR, FAMILY ECONOMIC SECURITY, NATIONAL WOMEN'S LAW CENTER**

Ms. ENTMACHER. Thank you, Mr. Chairman. I appreciate this opportunity to testify on behalf of the NWLC. My written testimony addresses some of the system design issues presented when individual workers, particularly women, try to convert the proceeds of a private account into a secure and equitable income throughout

retirement. Other witnesses have addressed some of these issues, my remarks will focus on the question of whether and how the proceeds of a private account are to provide for the spouses, surviving spouses, divorced spouses, and children who rely on the family insurance benefits that Social Security provides. These issues are of special importance to women. Nearly 14 million Americans receive a spousal benefit from Social Security, and 98 percent of those who do are women. So, women need to know when things like “personal lockboxes” are described, what will be the rights of a spouse, a widow, a divorced spouse to the funds in those accounts if Social Security spousal benefits are cut as part of a private accounts plan, and many private accounts plans do cut those benefits.

At retirement, for example, will married workers be required to purchase a joint and survivor annuity to protect a surviving spouse the way Social Security does? Without such a requirement, a widow could be left with absolutely nothing from his account to supplement her own probably lower Social Security benefit and private account. Adding insult to injury, she could be facing an additional reduction in her Social Security widow’s benefit precisely because he elected to participate in a private account. Requiring the purchase of a joint and survivor annuity would help protect elderly widows from impoverishment and promote fairness. There are real trade-offs, which perhaps is why the Administration has so far failed to answer this very basic design question. Under Social Security, a worker’s benefits are not reduced because Social Security provides payments to a surviving spouse. A private account is a finite sum of money. Purchasing a joint and survivor annuity means the worker will get lower payments.

Ms. Mitchell has suggested that accounts should be annuitized to provide a poverty level benefit for both the worker and spouse. This is not a requirement the President has talked about so far, possibly because, the fact is, many accounts simply will not be large enough to provide such benefits for both people. In addition, annuities are inflexible. They cannot respond to changes in marital status that may occur after an annuity is purchased. Whether one is widowed right before or right after annuitization could make a big difference in what the widowed individual receives.

Then there are subsidiary questions: How large a survivor annuity should be provided, and should waivers be permitted? Second, will workers be permitted to leave an account to anyone, as the President has sometimes said, or would widows have the right to an inheritance from the account to mitigate the impact of cuts in survivor benefits? If a young widow does inherit account assets, would she have immediate access to the funds to help support her family and supplement their reduced survivor benefits, or would she be required to keep that money aside for her own retirement, as several plans provide? Along with an inheritance from the account, would she inherit the obligation to pay back Social Security with interest out of a reduction in her own Social Security benefits later? Would the requirement to pay back Social Security apply to other heirs, and would they have access immediately to the accounts? What about minor children and adult disabled children who are entitled to Social Security benefits on a worker’s record,

would they have a right to inheritance from an account to offset cuts in those benefits?

Third, how would accounts be divided at divorce? One approach that has been suggested would divide the assets that accumulate in accounts during the course of a marriage equally between spouses. It sounds simple. It isn't. Simply implementing the division of accounts at divorce will require new reporting, verification, and dispute resolution mechanisms well beyond those needed to administer either the current Social Security System or the thrift savings system. About 100,000 applications for Social Security each year involve establishing evidence of divorce. There are 10 times as many divorces each year in the United States. The SSA doesn't need to track marital status over the lifetime. It just figures it out when application is made for benefits, and those benefits are based on the worker's record. The TSP doesn't need to do this either. It just follows the instructions that it gets from a State divorce court. If a woman doesn't have a lawyer, and doesn't know to ask for a share of a thrift savings account in a divorce, she gets nothing. I would point out right now there is no national registry with information about marriages and divorces in the United States. To divide accounts based on contributions during marriage would require the creation of such a registry, and, apart from the cost, that would raise a lot of new confidentiality issues.

Finally, one last point. In a system of voluntary personal accounts, what would happen if one spouse decides to participate and the other doesn't? How would any of the rules created apply? I think the simplest answer to these questions would be to focus on strengthening the safety net that Social Security currently provides, rather than shifting resources into private accounts. Thank you.

[The prepared statement of Ms. Entmacher follows:]

**Statement of Joan Entmacher, Vice President and Director, Family Economic Security, National Women's Law Center**

Chairman McCrery, Ranking Member Levin, and members of the Subcommittee, thank you for this opportunity to testify on behalf of the National Women's Law Center.

My testimony will focus on the administrative and implementation issues that would arise at the point that money is to be paid out of private accounts created as part of Social Security. So far, most of the discussion of administrative issues has focused on how a new system of accounts would be created, how money would get into the accounts, and how investments during the working years would be managed. Far less attention has been paid to questions of how, if, and when money would be paid out from accounts to workers and their family members.<sup>1</sup>

The administrative issues that arise at the payout phase are critically important. If private accounts are supposed to make up for reductions in Social Security benefits that now provide basic income security for tens of millions of Americans and their families, a key question is, how can the proceeds of an individual account be converted into a secure, equitable, and adequate source of income for workers—and their spouses and children—when workers retire, die, or are disabled?

My testimony first discusses some of the issues that arise with payouts at retirement to an individual worker, then moves to some of the even more complex issues

<sup>1</sup>This testimony is informed by my work as a member of the expert study panel convened by the National Academy of Social Insurance to examine issues relating to the payment of benefits from individual accounts, two years of discussion with the thoughtful and knowledgeable experts on the panel and the NASI staff, and the report issued by the panel earlier this year: Reno, Graetz, Apfel, Lavery and Hill, eds, National Academy of Social Insurance, *Uncharted Waters: Paying Benefits from Individual Accounts in Federal Retirement Policy* (2005) [*Uncharted Waters*"]. However, I am testifying today solely on behalf of the National Women's Law Center.



that arise because Social Security is a family insurance plan, not just a worker retirement program.<sup>2</sup> The questions raised are difficult, and the tradeoffs presented are inevitable and painful, because an individual account simply cannot substitute for the range of insurance protections that it is possible to provide for workers and their families through Social Security.

There may be a temptation to think that resolving these issues can wait, because the retirement of workers who establish an account would be several years away. But that would be a serious mistake. Workers will need to know what the payout rules are before they can make a decision about whether or not to contribute to a private account. Well before they reach retirement age, some workers will divorce, some will become disabled, some will want access to the funds in “their” accounts, and some will die—all events that require decisions about payouts from private accounts, decisions that will have serious consequences for the wellbeing of Americans who rely on the safety net that Social Security provides for them and their families.

#### **How Will Private Accounts Provide Secure Lifetime Income to Individuals When They Retire?**

When a worker retires, dies, or becomes disabled, Social Security provides the worker and eligible family members with benefits that cannot be outlived, are adjusted annually for inflation, and do not fluctuate with the financial markets. In contrast, private accounts represent a limited pool of assets; retirees will face the challenge of deciding how to manage whatever they may have accumulated in an account to provide for their own retirement security, possibly for the financial security of a spouse or children, and for other goals. Administrative issues and financial risks do not end when a worker reaches retirement age. Retirees must make decisions in the face of multiple uncertainties: how long they or a spouse might live, how much prices will rise, and how the financial markets will perform.

The challenges of managing private savings throughout retirement are not limited to accounts created within Social Security. But the stakes are higher—and the issues more complex—if private accounts are being relied upon to help make up for reductions in the basic income that Social Security provides to workers and their families.

- *How will workers be protected against outliving the assets in a private account?*

With a plan that cuts Social Security benefits and relies on private accounts to provide basic income security to retirees for the rest of their lives, Congress will have to decide whether, when, and to what extent to require workers to purchase a life annuity to insure against the risk of outliving the assets in the account and becoming impoverished in old age. Alternatives to life annuities have been suggested as a way of preventing workers from exhausting their accounts too quickly, such as taking phased withdrawals over the period of their projected life expectancy. However, phased withdrawals do not provide the assurance of lifetime income; indeed, as the Congressional Research Service notes, on average, about 50 percent of those opting for phased withdrawals will live longer than expected and exhaust the funds in an individual account.<sup>3</sup> Making the purchase of a life annuity mandatory, at least to assure income up to some specified level, would reduce income insecurity; broaden the annuity pool and increase annuity payments on average; and reduce marketing expenses.<sup>4</sup>

But requiring the purchase of an annuity poses tradeoffs. An annuity requires payment up front; once it is purchased, the assets used to buy it are no longer available. An annuitization requirement would reduce the risk of outliving assets, but also would reduce the control and choice workers could exercise over the accounts. An annuitization requirement also could eliminate the possibility of a bequest; the Bush Administration estimates that under its plan, 15 percent of all retirees and 30 percent of retirees with lower lifetime incomes would have to spend all the assets in their accounts to bring the combination of reduced Social Security benefits and payments from the account up to the poverty level for their lifetimes, leaving nothing in their accounts for discretionary spending or a bequest.<sup>5</sup>

<sup>2</sup>For more information about the family insurance benefits that Social Security provides, and their special importance to women, see Testimony of Nancy Duff Campbell, Co-President, National Women's Law Center, to the Subcommittee on Social Security, Committee on Ways and Means (May 17, 2005) [“Campbell Testimony”].

<sup>3</sup>Laura Haltzel, Congressional Research Service Report, *Social Security Reform: President Bush's Individual Accounts Proposal* 7 (April 25, 2005).

<sup>4</sup>See *Uncharted Waters*.

<sup>5</sup>[5] Associated Press, “Survivor Benefits Face Cut, Official Says,” (May 12, 2005).

- *Will discrimination on the basis of gender be prohibited in annuities purchased from private accounts?*

Social Security pays monthly benefits on a gender-neutral basis. In contrast, in the private annuity market, if a man and woman purchase a life annuity with the same amount of money at the same time, the woman will get lower monthly payments for life.

Federal law already bans differential pricing and benefits in group annuities or pensions that are part of an employment relationship.<sup>6</sup> If Congress creates private accounts as part of Social Security, it must prohibit gender discrimination in annuities marketed to those with private accounts. An effective prohibition on discrimination will require more than passing legislation; regulatory oversight be needed to avoid the design and marketing of annuity products specifically to men or women to avoid the effect of the uniform pricing requirement.<sup>7</sup>

- *How will annuities from private accounts provide protection against inflation?*

Social Security provides payments for life that are adjusted annually to keep up with increases in the cost of living. No private annuities currently offer full protection against inflation, and experts believe they are unlikely to evolve without the substantial involvement of the federal government, even if the market for private annuities expanded with the establishment of private accounts.<sup>8</sup>

- *How will workers be assured that annuity payments from a private company will continue for life?*

A person who purchases a life annuity pays the price up front, in exchange for a contractual promise to make payments for the life of the purchaser (and survivor, in the case of a joint and survivor annuity). The purchaser counts on the company providing the annuity to make good on the promised payments for years to come.

Today, life annuities are provided by life insurance companies that are regulated by the states. States are responsible for setting solvency standards, monitoring compliance with those standards, and providing some protection in case an insurance company defaults. Every state has a “guaranty fund” to deal with defaults—but unlike the Federal Deposit Insurance Corporation, which ensures bank deposits, or the Pension Benefit Guarantee Corporation, which ensures defined benefit pensions, state guaranty funds are not pre-funded at all.<sup>9</sup> In the event of a default, states make assessments against other companies doing business in the state. States also make their own rules about who is protected, and to what extent, by the state guaranty.<sup>10</sup> For example, a retiree who purchases an annuity from a company doing business in state A, then moves to State B, may not be entitled to payments from State A’s guaranty fund if the company defaults.<sup>11</sup> The risk that a large insurance company will default is not hypothetical, as the case of the Executive Life Insurance Company of California and its New York subsidiary shows; as this case also shows, policy holders may suffer substantial losses in case of default.<sup>12</sup>

If Congress creates private accounts that are designed to replace Social Security income, the federal government will have to intervene in the annuities market, and probably act as guarantor, to make sure that Americans get the payments they are counting on. But Social Security already provides annuities that are adjusted for inflation, nondiscriminatory, and secure; it would be far more efficient and effective simply to protect and strengthen Social Security.

- *When will retirees be required to purchase the annuity?*

Investment risk does not end when a worker has stopped contributing to an account is ready to start drawing retirement income. Indeed, converting account assets to a life annuity magnifies market risk. The lifetime income that an annuity provides will be determined by the value of the assets and interest rates at the moment of conversion—and these can fluctuate greatly over short periods of time. The drop in the stock market and interest rates between 2000 and 2003 meant that a retiree purchasing an annuity in 2003 would have 60 percent less income than a retiree

<sup>6</sup>See, e.g., *City of Los Angeles Department of Power and Water v. Manhart*, 435 U.S. 702 (1978).

<sup>7</sup>See *Uncharted Waters* at 78–80.

<sup>8</sup>See *Uncharted Waters* at 85–86.

<sup>9</sup>*Id.* at 76–82.

<sup>10</sup>*Ibid.*

<sup>11</sup>*Ibid.*

<sup>12</sup>*Ibid.*

who purchased an annuity in 2000—after a lifetime of making similar contributions and investment choices.<sup>13</sup>

These market fluctuations are a source of concern—and hardship—for workers in or near retirement who look to their IRAs or 401(k)s to supplement their Social Security benefits during a market downturn. When private accounts are expected to replace part of the basic income provided by social insurance system, the risks are even greater.

In Chile, interest rates fell dramatically in 1996 and 1997, greatly reducing the lifetime payments workers would get from their accounts. Under Chile's partially privatized system, which requires workers to annuitize their accounts when they claim retirement benefits, workers who had planned to retire—some of whom had already been pushed out of their jobs when they reached retirement age—were simply told, “Don’t.”<sup>14</sup> In the United Kingdom, protests by workers who were required to buy annuities under the UK's partially privatized system at a time when interest rates (and thus annuity payments) were down led the government, in 1994, to allow workers to defer their annuity purchase until age 75.<sup>15</sup> But many workers don't have sufficient other resources to meet their needs while they wait for market conditions to improve. And there is no guarantee of improvements in the short term; indeed, in 1999, *The Financial Times* reported that the income obtainable from a private account had dropped 16 percent in the course of a year.<sup>16</sup>

Giving workers flexibility in the timing of an annuity purchase raises new issues and administrative challenges; indeed, an extended time frame could essentially negate an annuitization requirement. Many workers would be unable to get by on their greatly reduced Social Security benefits while they wait for market conditions to improve; but, if they are allowed to start withdrawing assets from the accounts while they wait to annuitize, there will be less left in the account to assure lifetime income for workers and their spouses.

Deciding when to annuitize carries lifetime financial implications; to take advantage of the added flexibility, workers will need additional financial counseling (not that investment counselors are necessarily successful at predicting short-term changes in asset values and interest rates). Gradual annuity purchases could spread the risk of interest rate fluctuations over a longer period—but would not eliminate the risk, and would add to administrative costs and make payment levels uncertain.<sup>17</sup>

Workers deciding when to annuitize could be subject to conflicting family pressures: children and other possible heirs may seek to delay the purchase of an annuity which would leave little or nothing for them to inherit; a spouse concerned about the depletion of assets may prefer the purchase of a joint and survivor annuity. And workers with lower-than-average life expectancies would probably seek to delay the purchase of an annuity as long as possible; life annuities are not a good deal for people with shorter life expectancies. But if individuals with shorter life expectancies can effectively opt out of the annuity pool by delaying the purchase of an annuity for years, those who purchase annuities can expect lower payments.

#### **How Will Private Accounts Help Make Up for Cuts in the Family Insurance Benefits that Social Security Provides?**

The various family insurance benefits that Social Security provides, and their importance—especially to women and their families—are described in the May 17, 2005 testimony to this Subcommittee by Nancy Duff Campbell, Co-President of the National Women's Law Center. Her testimony also explains why private accounts cannot match the benefits that Social Security provides not just for retired workers, but for workers if they are disabled, and for the spouses and children of workers when workers retire, die, or are disabled.

The best way to protect the safety net that Social Security provides for women and their families is to reject plans that would create private accounts out of Social Security, and work instead to strengthen and improve Social Security.

However, if this Subcommittee is considering private accounts plans, it must consider how the rules governing the payouts from private accounts might mitigate—or exacerbate—the harm to family members and disabled workers from the plan's cuts to Social Security benefits—even though it will be impossible to protect them fully.

<sup>13</sup>[13] Calculations by Gary Burtless, Senior Fellow, Brookings Institution, quoted in Julie Kosterlitz, “Cracking the Nest Egg,” *National Journal* (April 22, 2005).

<sup>14</sup>*Ibid.*

<sup>15</sup>*Ibid.*

<sup>16</sup>*Ibid.*

<sup>17</sup>Uncharted Waters at 70.

- *Will married workers be required to purchase a joint and survivor annuity?*

Social Security assures the spouse of a retired worker a benefit equal to 50 percent of the worker's benefit; it assures the surviving spouse a benefit of 100 percent, assuming both spouses retire at full retirement age. Divorced spouses and divorced surviving spouses, if married to the worker for at least ten years, are entitled to the same benefits as current spouses. Social Security spousal benefits are paid in addition to the worker's benefit; they do not reduce the benefit that the worker, or the current spouse (or ex-spouse) of the worker receives.

Because Social Security spousal benefits are calculated based on the worker's Social Security benefit, cuts in Social Security benefits for retired workers mean cuts in spousal benefits as well. Private accounts plans may cut spousal benefits twice: first, as part of a general benefit reduction applicable whether or not a worker has chosen to contribute to a private account (even if these cuts are designed to exempt workers with very low earnings, widows with very low income may face benefit cuts, because their benefits are based on the record of a worker who had earnings above the minimum level). Second, if a plan cuts benefits specifically for workers who contribute to a private account, benefits for the retired spouse and widow of a worker who contributes to an account are also likely to be cut further.<sup>18</sup>

In view of the importance of spousal benefits to women, now and in the future, it is disturbing that the Administration has so far failed to say whether its private accounts plan would require married workers to purchase a joint and survivor annuity to help make up for reductions in Social Security spousal benefits. Without such a requirement, a married worker (call him Michael) could convert all the assets in his account to a single life annuity, leaving his widow (call her Sarah) with nothing from the account: no household income from his annuity payments, no survivor payments for herself, and no inheritance. Yet she may be facing a deep reduction in her Social Security benefits specifically because Michael contributed to a private account.<sup>19</sup>

In addition to deciding whether to require the purchase of joint and survivor annuities, Congress also must decide their size and form. What percentage of the payment to the annuity purchaser should be required to be provided for a surviving spouse: 50, 67, 75 or 100 percent? A higher survivor benefit means more income security for the widowed spouse—but lower payments when both are alive. If the spouse is several years younger, payments during the life of the annuity purchaser would be lower still.

Requiring survivor annuities will provide additional protection to surviving spouses, but they cannot respond to changes in marital status as Social Security can. Someone who enters retirement as a single individual, purchases a single life annuity, then marries, cannot change it to a joint and survivor annuity. Someone who is widowed or divorced shortly after retirement cannot change a joint and survivor annuity to a single life annuity with higher payments. And whether one is widowed right before or after annuitization could make a big difference in what the widowed individual receives.<sup>20</sup>

- *Will waivers of the right to a joint and survivor annuity be permitted?*

There is no procedure in Social Security for a spouse, surviving spouse, or divorced spouse to waive the right to spousal benefits. Nor is there any need for such a waiver procedure; because the payment of spousal benefits in Social Security does not reduce benefits for the worker or current spouse, the issue does not arise.

Federal law requires that, in defined-benefit pension plans, the default pension payment to a married worker must be in the form of a joint and at least 50 percent survivor annuity, unless the spouse consents, in writing and before a notary, to a less generous or no survivor annuity.

In the context of retirement plans that are designed to provide tiers of income on top of the basic Social Security benefit, allowing for informed waivers of the right to a joint-and-survivor payment balances the competing goals of protecting the rights and needs of spouses and giving couples flexibility to make the financial arrangements that best meet their goals. The spouse with the right to a survivor payment may have other financial resources available, or both spouses may prefer to receive higher income when both are alive, even at the risk that the surviving spouse will only have Social Security to rely on.

<sup>18</sup> See *Uncharted Waters* at 174; no private accounts plan with an offset applied it only to the accountholder's benefit.

<sup>19</sup> For a further discussion of how annuitization choices could affect benefits for a couple, see Campbell Testimony.

<sup>20</sup> *Uncharted Waters* at 62–66.

However, in the context of a plan that cuts basic Social Security benefits, waivers would raise more difficult issues. The benefit cuts under some proposals could leave many workers with retirement income far below scheduled benefit levels, even if they maximized the payments from a private account by purchasing a single life annuity.<sup>21</sup> Providing a survivor annuity for a spouse would reduce the worker's benefits even further. Workers might pressure their spouses to waive the survivor benefit; even without undue pressure, some spouses might waive their right to a survivor benefit to ensure a modest income for the couple now—and worry about the future later. If waivers are permitted, information about the options and their implications would need to be provided to both spouses, adding to administrative responsibilities and costs.

- *Will workers be able to leave the account to anyone, or will surviving spouses have the right to inherit?*

The President has said repeatedly that under his plan, workers could leave an account to anyone, never suggesting that a surviving spouse would have the right to inherit. The Administration also has confirmed that its proposal would reduce benefits for widows and surviving children.<sup>22</sup> Congress must decide whether a surviving spouse will have a right to inherit account assets, and the nature of that right. Would it apply to all the assets in the account? Could it be waived?

Other questions would arise if a spouse inherits account assets, whether by right or designation. If a worker died young and left the account to his widow, would she have immediate access to whatever small amount the account might contain to help support her family and supplement their reduced survivors' benefits? Or would she have to save them for her own retirement, as several plans propose? With Social Security, a widow is eligible for benefits based on the deceased husband's work record both while she is raising their children and at retirement—but funds in a private account can only be used once.

If account assets went to someone other than a surviving spouse, would those heirs have immediate access to the funds they inherit?

Would children have any inheritance rights in a parent's account, especially if a private accounts plan cuts their survivor benefits? If the children live in a different household than the widowed spouse—a not uncommon situation—how would their interests be balanced? What would happen if a child made a claim after all the assets in an account had been distributed—as could happen, if the deceased parent had not had contact with the child for several years? Would all children have inheritance rights, or only minor children and disabled adult children entitled to benefits on the parent's work record? If the latter, would the child's share be related to the number of years the child would be reliant on reduced survivor benefits, so that a toddler or disabled adult child would be entitled to a greater share of a parent's account than a school age child? These questions highlight the impossibility of expecting a private account to make up for cuts in the life insurance benefits that Social Security provides to surviving spouses, surviving divorced spouses, and children.

If a plan provides that workers must pay back the money they contributed to a private account, with interest, out of a reduction in their Social Security benefits, would the widow inherit this debt along with any assets in the account? If so, would other heirs have the same obligation? Transferring a debt along with account assets would greatly diminish the value of any inheritance; in fact, if the account has done very poorly, the bequest could be a net liability. On the other hand, Social Security's finances will suffer if funds diverted from Social Security to private accounts are not reimbursed by those who benefit from them.

- *How would accounts be divided at divorce?*

Social Security provides benefits for divorced spouses and divorced surviving spouses who have been married for at least ten years. Benefits for divorced spouses are calculated in the same way as benefits for spouses and surviving spouses, based on the full work history of the higher-earning spouse, not just the earnings during the period of the marriage.

The question of how accounts should be divided at divorce raises fundamental legal questions.<sup>23</sup> If private accounts are considered "property," they might be subject to state laws concerning marital property—which differ between community property and common law states, and among the states in each group. This would lead to different rights for spouses in community property and common law states, and for couples or individual spouses who move from state to state. Congress could

<sup>21</sup> See Campbell Testimony.

<sup>22</sup> Associated Press, "Survivor Benefits Face Cut, Official Says," May 12, 2005.

<sup>23</sup> For an explanation and further discussion, see *Uncharted Waters* at 120–137.

create a uniform system of federal rules governing the division of accounts at divorce and other spousal rights issues—or explicitly certain issues to the operation of state law—but it must explicitly resolve the issue of whether state or federal law will govern.

There are several possible approaches for dividing accounts between spouses.<sup>24</sup> One approach would involve contribution splitting during marriage—that is, contributions to accounts made by either spouse during the marriage would be shared equally between the spouses' accounts. Because contributions would have been shared at the front end, there might be no further division of account assets at divorce. Another approach would divide the assets that accumulated in the accounts during the course of the marriage equally between the spouses. Or this 50–50 division could be the default, but other allocations could be allowed by agreement of the parties or a court order.

If a plan provides that workers must pay back the money they contributed to a private account, with interest, out of a reduction in their Social Security benefits, Congress also must decide if and how the debt, as well as account assets, should be divided at divorce.<sup>25</sup>

Implementing a system for dividing private accounts at divorce, even one that calls for the automatic 50–50 division of accumulations during the marriage at the time of divorce, will require new reporting, verification, and dispute-resolution mechanisms well beyond those needed to administer the current Social Security system. Social Security needs to review evidence of marriage, marriage duration, and divorce only at the point an individual applies to receive Social Security benefits as a divorced spouse or divorced surviving spouse. Approximately 100,000 new applications for Social Security in 2001 involved evidence of divorce—but that is just one-tenth of the roughly one million divorces that occur each year in the United States.<sup>26</sup>

Benefits for eligible divorced spouses are based on the full work history of the higher-earning spouse, so Social Security needs no additional information to calculate benefits for an eligible divorced spouse. To divide contributions and accumulations during only the period of the marriage would require historical records of year-by-year (or quarter-by-quarter) contributions and investment earnings, along with evidence and dates of marriage and divorce.

For the entity administering a system of private accounts to obtain reliable information about marital status is no simple matter; no national registry of marriage and divorce information currently exists.<sup>27</sup> Creating such a registry would require new resources and raise new confidentiality issues. Individuals could be asked to report changes to their marital status. But accountholders might fail to report a marriage, because they would prefer that a spouse not receive funds at their expense. Social Security minimizes conflicts and disputes, because the payment of benefits to a divorced spouse does not reduce payments for the worker or his or her current spouse.

Once an account is divided at divorce, the assets are gone. The spouse who is the net loser in the division will have less in an account to supplement reduced retirement benefits or provide for children or a new spouse.

- What if only one spouse participates in a private account?

If participation in a private account is voluntary, there will be spouses who have made different decisions with respect to participation. Such differences cannot be eliminated by requiring married couples to make the same choice (and deciding whether participation or nonparticipation is the default if they cannot agree). Many Americans enter the labor force before they get married, and, under some plans, would make an irrevocable choice at that time; new marriages and remarriages would produce additional mismatches.

### Conclusion

This testimony raises some important issues about the critical payout phase of a private accounts plan.<sup>28</sup> Some of these questions have been raised before—but many still have not been answered by the Administration. Before this Committee considers proposals that would radically change a program on which millions of Ameri-

<sup>24</sup> Six options are identified in *Uncharted Waters* at 127.

<sup>25</sup> See *Uncharted Waters* at 178–179.

<sup>26</sup> *Uncharted Waters* at 133.

<sup>27</sup> See *Uncharted Waters* at 134–135.

<sup>28</sup> For a further discussion of these issues, and the many issues concerning payments to people with disabilities and their families which this testimony does not address, see *Uncharted Waters*.

cans rely, it must address the fundamental questions: how would an account that fluctuates with the market provide a secure, basic retirement income, and how would an individual account make up for reductions in the family insurance benefits that Social Security provides.

---

Chairman MCCRERY. Thank you. Mr. Cavanaugh.

**STATEMENT OF FRANCIS X. CAVANAUGH, FORMER EXECUTIVE DIRECTOR AND CHIEF EXECUTIVE OFFICER, FEDERAL RETIREMENT THRIFT INVESTMENT BOARD**

Mr. CAVANAUGH. Thank you, Mr. Chairman, Members of the Subcommittee. I welcome this opportunity to discuss the administration of Social Security personal retirement accounts. My comments will focus on the President's current proposal for such accounts. The critical question, of course, is cost. Individual accounts are proposed to provide a higher investment return than would be realized by the Social Security Trust Fund. On this basis, individual accounts would not be feasible for the 68 million employees of 98 percent of the businesses in the United States. That is the 5.6 million small businesses with fewer than 100 employees. It just would not work.

To understand the cost to small business, we must first understand why 85 percent of them do not now have retirement plans. A major reason is that the 401(k) industry has found that it cannot profitably provide services for a company for less than approximately \$3,000 a year. This is after 10 years of competing with each other and the economies of scale. So, even though they enjoy these economies of scale when combining thousands of employers in their centralized computer system, they cannot reduce the cost below this. Further, significant economies of scale would not be realized by a central Federal TSP-type agency because of the fixed costs of reaching out to millions of small businesses. Nor can we assume that a new central government agency would be more efficient than the major 401(k) providers who now serve this market. Thus, the cost per employee of a company with ten employees would be \$300, or 30 percent of the President's proposed initial annual individual account contribution of \$1,000. Most U.S. companies have fewer than ten employees.

Accordingly, the initial expense ratio for employees of the average-size business would be more than 3,000 basis points, or 100 times the Administration's estimate of 30 basis points. This is not conjecture, Mr. Chairman, this is based on what the market is actually doing and saying right now. Obviously, since the administrative costs of individual accounts would exceed their estimated returns from investments, a substantial government subsidy would be necessary to make the individual accounts attractive to employees of small business. If all Social Security taxpayers eventually participated in the individual account program, the administrative costs would be more than \$46 billion a year. In addition to the above costs, which are based on what the current providers are actually charging for establishing and servicing 401(k) plans, there are overwhelming practical obstacles to modeling individual accounts on the TSP or private 401(k) plans.

First, the TSP is administered by just one employer, the U.S. government, with an extensive network of agency personnel payroll and systems staff to provide the essential employee education, retirement counseling, payroll deduction, timely fund transfers, error correction functions, and so on. These essential employer services in 401(k) plans could not possibly be performed by small business employers or by a new TSP-like central agency. It cannot be done. Second, the TSP is computerized, like all other large plans, with investments made promptly after contributions are deducted from the employee's paycheck. With individual accounts it would be up to 22 months after payday under current SSA procedures before the individual accounts could be credited and invested. Third, the TSP is balanced to the penny every day. The Social Security system is never balanced. Each year there are billions of dollars of unreconciled discrepancies. Fourth, the TSP and the Federal employee agencies have a very effective system of communication. The TSP mailings consistently have reached more than 99 percent of employees, but 25 percent of Social Security mailings are returned as undeliverable.

Since individual accounts are certainly not feasible for employees of small business, the only practical way to give higher returns for Social Security beneficiaries generally, including small business employees, is to invest part of the Social Security Trust Fund in equities. The likely increase in trust fund earnings would be an effective way to help maintain the solvency of the trust fund. Every State in the United States has authorized public retirement fund investment in stocks which can now be done through broad-based index funds, which avoid the problem of direct government control over a particular company. There is no longer any reason not to invest the trust fund partially in equities. As is shown in the chart on page eight of my statement, there is even less government influence over private companies under the trust fund alternative than under the TSP or the Administration's plan.

In conclusion, the Administration's plan for universal, individual accounts is not feasible. The way for the Social Security system to capture the higher returns available from investments in stock is to diversify the Social Security Trust Fund investments. The trust fund alternative, compared to individual accounts, would be less disruptive of financial markets, would save tens of billions of dollars a year in administrative costs, and could be effective virtually immediately rather than the 2009 starting date proposed for individual accounts. The multi-trillion-dollar transition costs of individual accounts would be avoided. The additional trust fund earnings would go a long way to strengthening Social Security finances and would thus reduce, if not eliminate, the need for significant tax increases or benefit reduction. Thank you for your attention. I would be happy to answer any questions.

[The prepared statement of Mr. Cavanaugh follows:]

**Statement of Francis X. Cavanaugh, former Executive Director and Chief Executive Officer, Federal Retirement Thrift Investment Board**

Mr. Chairman and Members of the Subcommittee:

I welcome this opportunity to discuss the administration of Social Security personal retirement accounts (PRA). My comments will focus on the Administration's current proposal for such accounts.



I am a public finance consultant, but I speak only for myself. I have no clients with an interest in Social Security individual accounts. From 1986 until 1994, I was the first Executive Director, and thus the chief executive officer, of the Federal Retirement Thrift Investment Board, the agency that administers the Thrift Savings Plan (TSP) for federal employees. Before that, I was a financial economist in the Treasury Department for 32 years, and was the senior career executive responsible for developing federal borrowing, lending, and investment policies, including those for the Social Security and other federal trust funds.

### **The Administration's Proposal**

While there is no specific proposal before your committee, the Administration's current broad proposal, according to White House statements and press reports, provides a basis for at least a preliminary analysis of its administrative feasibility.

The following features of the Administration's approach would have significant impacts on its feasibility:

- PRAs would be voluntary for all Social Security taxpayers under age 55, but would be mandatory for employers of employees who chose PRAs.
- A major purpose of PRAs would be to encourage savings by young and low-income workers and employees of small businesses who do not now have 401(k)s or other pension plans.
- The maximum amount of an individual's initial annual contribution to a PRA would be \$1,000, which would increase by \$100 a year, to 4 percent of pay eventually. It would take more than 30 years for the highest income individuals to be able to contribute the full 4 percent of pay.
- Eligible investments for PRAs would be Treasury securities and stock and bond index funds, which would be similar to eligible investments of the TSP.
- PRAs would be centrally managed, apparently by a TSP-like agency with a part-time board, appointed by the President with the advice and consent of the Senate, and a full-time executive director and CEO appointed by the board. Following the TSP model, the board members and the executive director would be independent of the Administration, and would be fiduciaries required to act solely in the interests of the holders of the PRAs and their beneficiaries.
- Unlike contributions to 401(k)s or to the TSP, PRA contributions would not be eligible for matching contributions or exclusion from taxable income, and loans or withdrawals before retirement would not be permitted.

### **Cost Analysis**

A critical question, of course, is costs. PRAs are proposed to provide a higher investment return than would be realized by the Social Security trust fund. Thus PRAs would not be feasible if their administrative costs were so high as to offset the advantage of diversified investments in stocks and other securities that yield more than the Treasury securities in the Social Security trust fund.

The Administration assumes that PRAs would earn an average investment return of 4.9% after inflation, and that administrative costs of 3%, that is, 30 basis points, would reduce the net return to 4.6%, or 1.6% more than the assumed net return of 3% on the Treasury securities in the Social Security trust fund. Thus, if one accepts the Administration's assumptions, PRAs would outperform the trust fund investments so long as the administrative costs were less than 1.9%. In my view and that of many other economists, the 4.6% assumption is much too high; indeed, the Congressional Budget Office's estimate of the net return is reportedly only 3.3%.

The Administration's estimate of 30 basis points is optimistically low; even the Cato Institute, a leading advocate of individual accounts, estimates PRA expenses at 55 basis points. Yet this higher estimate is also too low. Like so many others I have heard, these estimates are based mainly on experience with large 401(k)s for large organizations, like the TSP,<sup>1</sup> with economies of scale and comprehensive payroll, personnel, and computerized systems support. They have little relevance to the likely costs of a universal system of PRAs. More than 85 percent of the 5.6 million small business employers in this country offer no pension plans at all and, accordingly, have *none* of the administrative apparatus to service them.

To understand the costs of bringing PRAs to employees of small businesses, we must first understand why 85 percent of them do not now have retirement plans for their employees. Fortunately, the 401(k) industry has already done part of the job for us. Companies like Citigroup, Fidelity Investments, Merrill Lynch, State Street Corporation, and T. Rowe Price have been competing for two decades to provide investment, record keeping, counseling, and other 401(k) plan services to small

<sup>1</sup> The administrative cost, or expense ratio, of the TSP is 6 basis points.

businesses. They have found that they cannot profitably provide these services for a company for less than approximately \$3,000 a year, even though they have for years enjoyed economies of scale from serving thousands of employers in their centralized computer systems.<sup>2</sup> Further significant economies of scale would not be realized by a central TSP-type agency, because there would still be millions of small businesses or workplaces to be reached. Nor can we assume that a new central government agency would be more efficient than the major 401(k) providers who now serve this market.

Thus the cost per employee of a company with 10 employees would be \$300, or 30 percent of the President's proposed annual PRA contribution of \$1,000—and most U.S. companies have fewer than 10 employees.<sup>3</sup>

Even the largest business that is classified as a “small business,” one with 100 employees, would therefore have an expense ratio of at least 3 percent, which would be ten times the Administration's estimate of 30 basis points. And for the 60 percent of employers in this country that have fewer than 5 employees, the initial expense ratio would be more than 60 percent, that is, 6,000 basis points. In fact, commercial 401(k) providers routinely discourage small businesses from establishing 401(k) plans if they have fewer than 10 employees and, in some cases, fewer than 25 employees.

Obviously, substantial and continuing government subsidies would be necessary to make PRAs attractive to employees of small businesses. If all Social Security taxpayers participated in the PRA program, the administrative costs would be more than \$46 million a year (155 million participants times more than \$300 per account), which would be a subsidy to PRA administrators for performing an uneconomic function. These figures are reinforced by a number of studies, including those cited in a review of administrative costs by the Employee Benefit Research Institute.<sup>4</sup>

I recommend that your committee secure the testimony of individuals from financial institutions that are actually providing 401(k) services to the nation's businesses, large and small. Give them a specific set of assumptions to cost out that reflects the makeup of our country's 5.7 million employers subject to Social Security—of which 98% are small business employers of 68 million employees.<sup>5</sup> Then and only then will you know whether the Administration's proposal—or anything similar—will produce reasonable net investment returns, or, in the alternative, how much of a government subsidy would be necessary to achieve them.

### Critical Administrative Problems

In addition to the above costs, which are based on what the current providers are actually charging for establishing and servicing 401(k) plans, there are overwhelming practical obstacles to the creation and maintenance of PRAs. Because President Bush seemed to idealize the Thrift Savings Plan—the largest of all 401(k)-type plans—as the model for PRAs in his February 2005 State of the Union message—and because many others have done so as well—I would like to point out the considerable dissimilarities between the TSP and the Administration's proposal. (Most of these dissimilarities would hold true for a comparison between any large corporate 401(k) plan and the proposal.)

**Too Many Small Employers.** The TSP is administered by just one employer—the U.S. Government—with extensive personnel, payroll, and systems staffs to provide the essential employee education, retirement counseling, payroll deduction, timely funds transfers, and error correction functions. The Thrift Investment Board is only a wholesaler of services; the federal employing agencies deal with the individual employees participating in the plan. In fact, the TSP statute directs the Office of Personnel Management to provide for the training of TSP counselors for each federal agency.

The Administration's plan is intended to reach all employees, but it makes no provision for the performance of what are now essential employer functions in 401(k)

<sup>2</sup>Francis X. Cavanaugh, “Feasibility of Social Security Individual Accounts,” AARP Public Policy Institute, Washington, D.C., Sept. 2002, pp. 4–6. The \$3,000 charge is still common today. See “Big Fees Hit Small Plans: Costs Take Huge Toll on Retirement Accounts of Firms With Fewer Than 50 Employees,” Wall Street Journal, Oct. 31, 2004, p. D1.

<sup>3</sup>See generally U.S. Department of Labor, Pension and Welfare Benefits Administration, “Study of 401(k) Fees and Expenses,” Apr. 13, 1998. The study found that average charges by 17 major 401(k) providers for plans with 100 participants and \$2 million in assets ranged from \$114 to \$428 per participant, and averaged \$264. *Id.* at 51. Charges obviously would be much higher for much smaller plans.

<sup>4</sup>See, e.g., Employee Benefit Research Institute, Issue Brief No. 23, Nov. 1998. See also Ellen E. Schultz, “Poodle Parlor Retirement Plans,” Wall Street Journal, Nov. 13, 1998, p. C1.

<sup>5</sup>Patrick Purcell, Congressional Research Service, “Social Security Individual Accounts and Employer-Sponsored Pensions,” Feb. 3, 2005, pp. 3, 5.

plans. They could not possibly be performed by small business employers who are now responsible only for the relatively simple payroll deduction and transmission of Social Security taxes to the IRS. Since most businesses have fewer than ten employees, they do not have the experience or resources to support the new plan. These are barbershops, beauty salons, garages, restaurants, laundries, lawn services, households, nanny services, and other very small businesses that could not be expected to meet the high fiduciary standards required of those responsible for educating and counseling employees, for presenting a new plan in the context of the employer's existing pension or other benefits, and for the timely and accurate transfer of funds for investment. The new TSP-like agency obviously could not provide such employer-type services to deal with tens of millions of diverse employees, either directly or on a contract basis.

Consider, as but one example of several profound administrative and legal issues, that about 650,000 businesses go out of business *each year*. By whom and how would the enforcement of contributions by delinquent or bankrupt employers be prosecuted? (Judicial remedies for denial of TSP benefits must, in general, be pursued by the affected individual TSP participant in the federal court system.) For that matter, by whom and how would breach-of-fiduciary-duty suits be brought against "mom-and-pop" fiduciaries? Can the employer of a housekeeper or a manicurist be expected to exercise the "care, skill, prudence, and diligence" demanded of every 401(k) plan fiduciary by current law?<sup>6</sup> What would be the measure—and the limit—of their personal liabilities, say, for untimely or inaccurate investment of their employees' contributions? These questions only scratch the surface of the inevitable pathology of plan administration—pathology that, even if represented in small percentages among 155 million Social Security participants, would result in enormous absolute numbers.

**Untimely Investments.** The TSP is computerized, like all other large plans, with investments made for each employee's account on the same day that contributions are deducted from the employee's paycheck. Social Security taxes are deducted on paydays, but many small businesses send them to the IRS only once each quarter. In 2003, 72 percent of employer reports to the Social Security Administration were submitted on paper. Moreover, individual Social Security taxpayers are identified only once each year, with their employer's annual income tax filings; and it would be up to 22 months after payday, under current SSA procedures, before individual PRAs could be credited.

Furthermore, the Administration's proposal is to pay PRAs the same annual return, regardless of when contributions were actually made during the year. Thus a contribution in January would not earn any more than a contribution of a similar amount in December. During a year of highly volatile markets, the attempted explanation of this provision to millions of outraged participants with irregular tax payments, because of illness, seasonal, temporary, or other periods of unemployment, would be a daunting challenge to the plan's telephone counselors.

**Unbalanced Accounts.** The TSP is balanced to the penny every day. The Social Security system is never balanced. Each year there are billions of dollars of unreconciled discrepancies between Social Security taxes paid to the IRS and reported to the SSA. These discrepancies are tolerated because they generally have little impact on the ultimate calculation of employee benefits. Such discrepancies are never tolerated by financial institutions responsible for timely investment of individual funds. Theoretically, PRA contribution errors might be largely corrected by a rigorous examination of employer records. Yet the error correction procedures, including retroactive adjustments of investment gains or losses in volatile markets, could bring the entire system to a screeching halt.

**Inevitable Account "Leakage."** Unlike the TSP, the Administration's plan would prohibit loans and emergency withdrawals, and would require individuals to purchase annuities on retirement. I find it inconceivable, however, that Congress—or an Administration—would long be able to resist calls for emergency access to funds before a worker's retirement, and in lump sum amounts. Suppose, for example, that an individual has suffered a devastating personal financial loss, such as thousands experienced in last year's Florida hurricanes in the destruction of their homes. Would these persons be told that they may not access their PRA balances to mitigate such dire misfortunes? What about a catastrophic illness, leaving a family's breadwinner unable to work? Could such persons be denied their account balances to sustain spouse and children? I don't think so. There are, of course, scores more such examples, and with 155 million potential participants, you can be sure

<sup>6</sup>See Employee Retirement Income Security Act (ERISA), 29 U.S.C. § 1104(a); Federal Employees' Retirement System Act (FERSA), 5 U.S.C. § 8477(b)(1).

that they all would arise. Administering the inevitable emergency withdrawal or loan program would add enormously to the cost of the Administration's plan.

**Communication Problems.** The TSP has a very effective communications system, because it can rely on the federal employing agencies to distribute plan materials and to educate and counsel their employees. Even so, the TSP found it necessary to have the central record keeper for its 3 million accounts maintain a staff of more than 200 telephone counselors to respond directly to questions from individual participants. Since more than 200 million Social Security taxpayers and retirees eventually would be eligible for PRAs, the required number of telephone counselors would be more than 13,000, based on the TSP experience, and probably much higher because of the special PRA deficiencies noted above.<sup>7</sup> Also, TSP mailings consistently have reached more than 99 percent of participants, but 25 percent of SSA mailings are returned as undeliverable.

Congress would undoubtedly insist that every effort be made to advise all Social Security taxpayers of the PRA benefits Congress intended to provide them. The TSP sent summary plan documents to all 3 million eligible employees, which required 18 trailer trucks of printed materials. Similar documents would have to be sent eventually to the more than 200 million Social Security-covered employees and retirees.

The eventual costs of such massive efforts at this point are unknown, but they clearly would have a significant impact on PRA expenses.

**Small Employer Antipathy.** Even if small businesses were able to perform normal employer functions for PRAs, would they want to? PRAs would be voluntary for employees but, if employees elect to have PRAs, mandatory for their employers.

The TSP and 401(k) plans generally are enthusiastically sponsored and supported by the large employers who offer them as a major benefit for their employees, and as a means to move away from defined benefit retirement plans that require employers to bear substantial investment risks. The major attractions of the TSP and 401(k)s generally are the matching employer contributions and the immediate tax benefit from excluding employee contributions from taxable income. The ability to borrow or withdraw funds to meet emergency needs is also a significant benefit. PRAs, as currently proposed, would offer none of these benefits, and would be a relatively unattractive product that employers might be reluctant to support, especially small employers who do not have any pension plans. Moreover, it would be unrealistic to expect small-business employers to act as large corporate employers do in assuming the costs of investment losses because of, say, employer error in transmitting funds for timely investment of 401(k) accounts, or for myriad other commonplace employer errors. These serious concerns for small businesses would have to be addressed during congressional hearings on PRA proposals. (See the examples of legal issues on page 5 above.)

### **The Trust Fund Alternative**

Since PRAs are certainly not feasible for employees of small businesses—the vast preponderance of the business community—the only practical way to give them the higher returns available from equity investments is to invest part of the Social Security trust fund in equities. That way, the overwhelming administrative costs and practical problems of the Administration's plan would be avoided. The total administrative cost of having the Social Security trust fund invest in the private funds proposed for PRAs would be no more than one basis point, based on the actual costs of market investments by the Thrift Savings Plan. The likely increase in trust fund earnings would be an effective way to help maintain the solvency of the trust fund without having to resort to significant increases in Social Security taxes or reductions in benefits.

Every state in the United States has authorized public retirement fund investment in stocks. Yet the federal government still clings to the old notion that governments should not have an ownership stake in private companies, which made some sense when individual stocks were involved. Today's broad-based index funds, however, remove the investor from direct control over particular companies. Small business employees should not be denied the benefits of portfolio diversification in the Social Security trust fund simply because the federal government has not kept up with the states in understanding the evolution of financial markets.

**Less Government Influence Over Private Companies.** As shown in the following chart, there is even less government influence over private companies under the trust fund alternative than under the TSP or the Administration's plan.

<sup>7</sup>Fidelity Investments, a major 401(k) provider, has estimated that the administration of a 401(k)-type plan for Social Security taxpayers would require a total staff of 100,000. See Employee Benefit Research Institute, Issue Brief No. 23, Nov. 1998, p. 166.

*Government Influence Over Private Companies*

	Thrift Savings Plan	Administration Plan	Social Security Trust Fund Al- ternative
Selection of stock and bond index funds	Government decides	Same	Same
Selection of fund managers	Government decides	Same	Same
Selection of private record keeper	Government decides	Same	N/A
Selection of auditors and consultants	Government decides	Same	N/A
Selection of annuity providers	Government decides	Same	N/A
Selection of allocations among index funds	Individuals decide	Individuals decide	Government decides

N/A—not applicable. (There would be no need for private record keepers, auditors, consultants, or annuity providers for trust fund investments.)

**Special Benefits for Trust Fund.** Unfortunately, some political leaders have convinced many of the public that the Social Security trust fund is not really invested because it has been “looted,” and that the trust fund consists of “worthless IOUs.” Nothing could be farther from the truth, and such statements betray an apparent ignorance of federal finance in our highest circles of government. The trust fund is fully invested in the best securities in the world—U.S. Treasury obligations. Private trust funds invest in Treasury securities in the open market, but the Social Security trust fund buys its Treasury securities directly from the Treasury, which is more efficient than if the Treasury were to issue the securities in the market and then buy them back for the trust fund.

Moreover, the trust fund actually gets a much better deal than the private funds that buy Treasuries in the market. The trust fund, by law, may redeem its securities before maturity at par value, rather than at the sometimes deep market discounts suffered by private investors during periods of rising interest rates. Also, since the trust fund gets its securities directly from the Treasury, it avoids the market transaction costs which private investors must pay. Finally, the law requires the Treasury to pay the trust fund an interest rate on all of its investments in Treasuries equal to the average yield on long-term Treasury marketable securities. This is a significant benefit to the trust fund, since long-term rates are generally much higher than short-term rates. Thus in recent years, private investors have been earning about two percent on their short-term Treasuries, while the Social Security trust fund was earning about four percent on effectively the same maturities. The public seems to be totally unaware of these subsidies to the Social Security trust fund, which have been there for many decades.

**Trust Fund Dedicated to Social Security.** The assets of the Social Security trust fund consist of investments in Treasury securities solely for future beneficiaries. Yet political leaders from both parties complain that the Treasury has “spent” the trust fund surplus on government programs. What on earth do they expect the Treasury to do with the money—bury it in the Treasury’s back yard? The Treasury also spends the money it raises by issuing Treasury securities in the market. Does that mean that the private investors in Treasuries are also being “looted” by the Treasury? Of course not. The scandal would be if the Treasury left the trust fund uninvested and not earning interest. Then the Secretary of the Treasury would be in effect saying “*I don’t owe you,*” and that indeed would be a worthless IOU.

So why do government officials find fault with perfectly sound financial practices? From ignorance, as I suggested earlier?—or is it because they are trying to hide the real problem, which is the unique way the Social Security program is treated in the budget? Social Security expenditures are excluded from the budget and thus from the restraints on other government spending, which is proper since they are entitlements, and cannot be restrained under existing law. But the Social Security surplus is then, inconsistently, included in the calculation of the overall budget deficit, for the sole purpose of appearing to have achieved deficit, and thus spending, reduction. Then, having committed this accounting farce, officials have the audacity to complain that the misleading budget treatment of the trust fund surplus—which they could change—makes it available to finance other programs. The problem here is not the financing of the trust fund, but the political gimmickry of its budget treatment.

### Conclusion

In conclusion, the Administration's plan for universal PRAs is not feasible, and it should not survive the process of responsible Congressional hearings. The only practical way for the Social Security system to capture the higher returns available from investments in stocks is to diversify Social Security trust fund investments. The trust fund alternative, compared to PRAs, would involve less government influence over private companies, would be less disruptive of financial markets, would save tens of billions of dollars a year in administrative costs, and could be effective virtually immediately, rather than the 2009 starting date proposed for PRAs. The multi-trillion dollar transition costs proposed by PRA proponents would be avoided. The additional trust fund earnings would go a long way toward strengthening Social Security finances, and would thus reduce, if not eliminate, the need for significant tax increases or benefit reductions.

Thank you for your attention. I would be pleased to answer any questions.

---

Chairman MCCRERY. Thank you, Mr. Cavanaugh. Ms. Reno.

### STATEMENT OF VIRGINIA P. RENO, VICE PRESIDENT FOR INCOME AND SECURITY POLICY, NATIONAL ACADEMY OF SOCIAL INSURANCE

Ms. RENO. Thank you, Mr. Chairman, and thank you for the opportunity to be here today. I will present findings from a new study panel report from the NASI that is solely about how money would be paid from individual accounts. I think you all have a copy of the report available to you. This was the work of 27 top experts in various fields over a two-and-a-half year period led by bipartisan co-chairs, Michael Graetz of Yale Law School, who was a top Treasury official in the George Herbert Walker Bush Administration, and Ken Apfel, who is now at the LBJ School in Texas, and was Commissioner of Social Security during the Clinton Administration. The ten chapters in this report cover a host of payout issues about retirement, about annuity markets, early access to the money, disability, spousal rights, children's benefits, offsets, tax treatment and financial demographics. I will focus today simply on the retirement payout issues.

At retirement we face four kinds of risks. We don't know how long we will live, how long our spouses will live, how our investments will do, or how prices will rise. Social Security covers these risks by automatically adjusting benefits for inflation and paying spousal benefits. Individual accounts, in and of themselves, do not provide for those risks, but retirees, as Dr. Mitchell said, can buy annuities that turn their savings into a lifetime income. That is why annuities that pay out over a lifetime are so important. For a retiree, the good news about a life annuity is that your money will last as long as you live. The bad news about an annuity is you have to pay the full price up front. That is how they work. You can't change your mind. So, all of the money used to buy an annuity is not available to leave to heirs.

In a sense, an annuity is a chance to trade ownership for income security once you get to retirement. It is important to recognize also that more security in retirement will cost more. If a retiree wants inflation protection, his annuity will start out at a lower level. If he wants to make sure his wife has a survivor benefit, his annuity will start out again at a somewhat lower level. Essentially, when choosing these features, the retiree gets to choose current in-

come over future security. An important question our panel looked at is who would provide inflation-indexed annuities since all seem to agree that inflation indexing is very important. Our panel concluded that it would take some help from the Federal Government to have inflation-indexed annuities on a widespread basis. The government might issue a large volume of TIPS that my colleague mentioned, or it might simply issue the annuities directly to retirees. In either case, the government would be receiving a large amount of money for these transactions, either from TIPS investors for private annuities, or from annuity purchasers themselves. An important question that hasn't received much attention is how would the government manage, invest, or spend that volume of money it receives to facilitate inflation-indexed annuities?

Another key question is, will the government insure the insurers if annuities are provided privately? States now regulate insurance companies that provide life annuities. If Federal law required people to buy annuities, there might be an expectation that the Federal Government would also guarantee the solvency of those insurance companies. If so, it is important to think through what that guarantee would look like. Would it resemble the Federal Deposit Insurance Corporation or the Pension Benefit Guaranty Corporation? Essentially, that is a question that hasn't been fully resolved.

To wrap up, life annuities offer retirees the choice to trade ownership for retirement security or to trade current income for future security. The decisions have lifelong consequences for the retiree and his or her family. Retirees may need help to make informed choices. Finding and paying for good consumer education will be important. In terms of consumer education, there remains confusion today about exactly what we call annuities. Two different products are called annuities, in fact, and they are very different. Deferred annuities are investment products. They don't guarantee income for life. Life annuities are quite different. The deferred annuities are, in fact, more actively marketed and are a much bigger market than are life annuities. We are hearing stories today about how elders are being misled about deferred annuities and end up losing some of their lifetime savings.

To conclude, our cochairs have both emphasized that these payout issues with individual accounts are first-order questions, and it is really important that the Congress pay attention to them. We are glad that you are doing that today. Thank you.

[The prepared statement of Ms. Reno follows:]

**Statement of Virginia P. Reno, Vice President for Income and Security Policy, National Academy of Social Insurance**

Mr. Chairman and members of the Subcommittee, thank you for this opportunity to testify before you today. The National Academy of Social Insurance is a non-profit, non-partisan organization of the nation's leading experts on Social Security, Medicare, and related programs. Our mission is to promote sound policymaking on social insurance through research, education and the open exchange of ideas.

I will present findings of our new study panel report, *Uncharted Waters: Paying Benefits from Individual Accounts in Federal Retirement Policy*. Twenty-seven top experts contributed to this study. It was led by bi-partisan chairs, Mike Graetz of Yale law school and a top Treasury official in the George H. W. Bush Administration, and Kenneth Apfel of the LBJ School at the University of Texas and Commissioner of Social Security in the Clinton administration. The report is solely about how money would be paid out of individual accounts. Why are payouts important? Our co-chairs Mike Graetz and Ken Apfel said it best:

“Payouts are important because the central goal of Social Security is to assure some level of adequate income.” “To date, payouts have been largely neglected. Yet it is crucial that policymakers resolve issues in this report if they decide to add universally available individual accounts to our current system of providing retirement income.”

Our expert panel did not seek to agree on whether individual accounts in Social Security are a good idea. Nor did they agree on a blueprint for how to design payouts. Rather, they did agree that issues in this report are the right ones and how the questions get answered is critically important. The ten chapters cover such questions as:

(a) How would retirees get the money? (b) If annuities are required, who would provide them, and how? (c) Could workers get the money before they retire? (d) What rights would spouses have? (e) How would accounts affect disability benefits? (f) How would children be affected? (g) How might “offsets” affect payouts? (h) How would payouts be taxed? I will focus on retirement payouts. First, I summarize what we called “financial demographics” that set the stage for considering accounts.

### **Financial Demographics**

Social Security is the bedrock of income security for millions of Americans. The 47 million beneficiaries account for about one in six Americans living in one in four U.S. households. About two in three beneficiaries age 65 and older rely on Social Security for half or more of their total income. Women without husbands are the most reliant on Social Security; three in four such women over age 65 get half or more of their income from Social Security. For 44 percent of these women, Social Security is nearly all they have, making up 90 percent or more of their income.

Despite beneficiaries’ reliance on Social Security, the benefits alone do not provide a comfortable level of living. The average benefit for a retired worker was about \$955 a month, or \$11,500 a year in January 2005. Average benefits are somewhat lower for disabled workers (\$894) and elderly widows (\$920). Benefits for future retirees will grow somewhat more slowly than earnings, which will cause replacement rates to decline over the next 20 years as the age for full retirement benefits rises from 65 to 67. Benefits for 65-year-old retirees will replace a smaller share of prior earnings than is the case today or at any time in the last 30 years. Because Social Security is not in long-run financial balance, other changes might be enacted that will further lower benefits or raise revenue.

Employer-sponsored pension plans have covered about half of private-sector workers over the past 25 years. These plans are shifting away from the defined benefits that dominated the 1970s and 1980s to defined-contribution or 401(k)-type plans. The newer plans give workers more choices about whether to participate and how much to contribute; workers can take the accounts with them when they change jobs; and they have choices about when and how to withdraw the money. At the same time, workers finance more of the plans themselves and bear the investment risk that employers took on in defined-benefit plans.

In 2001, about half of all U.S. families owned a tax-favored retirement account. The median balance of those accounts was \$29,000. Older households had somewhat larger tax-favored savings, with a median value of \$55,000 for the 59 percent of families age 55–64 who had such accounts. Tax-favored savings are concentrated among high-income households; families in the top 20 percent of the income distribution held two-thirds of all tax-favored retirement savings.

The heavy reliance on Social Security among retirees up through the middle of the income distribution, the shift away from defined-benefit pensions, and increased use of 401(k) plans amplifies the importance of payout options that convert savings into guaranteed incomes during retirement.

### **Financial Risks for Retirees**

Retirees face four kinds of risks to their financial security. They don’t know how long they will live, how long their spouses will live, how their investments will perform, or how much prices will rise in the future. Social Security covers these risks by paying benefits for life, with automatic cost of living increases, and automatic survivor benefits. Individual accounts, in and of themselves, do not cover these risks. But retirees can buy life annuities that turn their savings into guaranteed income for life. That is why life annuities are important.

### **The Life Annuity Trade-Off**

From the retirees’ perspective, the good news in buying a life annuity is that your income will last as long as you live. The bad news is that you pay the full purchase price up front, and the purchase is irrevocable. All the money used to buy the annuity is no longer available to leave to heirs. For example, if you use \$40,000 to buy a life annuity and die a few months later, that \$40,000 is gone. The insurer uses



the money from people who die early to cover the costs of paying annuities to those who live a long time.

#### **More Protection Costs More**

If a retiree wants his annuity to keep up with the cost of living, it will start lower. If he wants it to continue to pay his widow after he dies, his payment will start out lower. For example, in one set of assumptions, a 65-year-old retiree with \$10,000 could buy a simple annuity of \$80 a month. If it is to keep up with the cost of living (at say 3 percent a year), it would start out lower, \$62 a month. If it would continue to pay as long either the retiree or his wife lived, it would start out at \$50 a month. (These prices assume everyone would be required to buy annuities. If annuities were optional, they would pay less than shown here because of what is known in the insurance world as *adverse selection*.)

#### **Guarantees Might Provide for Heirs**

Some annuities guarantee payments to a death beneficiary if the retiree dies shortly after buying an annuity. A 10-year certain annuity assures payment for 10 years if the annuitant dies in less than 10 years. This feature will lower the initial monthly payment to the retiree (from \$62 to \$58, in the above example, if the annuity is inflation-indexed).

#### **Changes in Marital Status**

In general, life annuities cannot be rewritten to shift from a single-life to a joint-life annuity if one marries after retirement. Nor can one “undo” the purchase of a joint-life annuity and shift to a single life annuity if a marriage ends shortly after buying an annuity. This could affect married couples’ decisions about whether and when to buy annuities. It could also produce very different incomes for widows depending on whether they were widowed before or just after buying annuities. For example, if John dies before buying an annuity, Mary could inherit his account, combine it with her own, and buy a single life annuity with the total amount. Consider this the base case. If instead, John and Mary both bought joint-life annuities, each would start out with a monthly payment that is about 81 percent of what a single-life annuity would provide. When one died, the survivor would receive 81 percent as much as the base case. The key point is that the timing of annuity purchase interacts with the timing of widowhood to produce very different results for retirees who are otherwise in similar circumstances.

#### **Who Would Provide Inflation-Indexed Annuities?**

Inflation-indexed annuities are very rare in the private insurance market. Our panel concluded that some help from the federal government would be needed to develop such a market. If the federal government increased the supply of long-duration (say 30-year) Treasury Inflation-Protected Securities (TIPS), insurers could use them to hedge inflation risk. Alternatively, the government could sell inflation-indexed annuities directly to retirees.

In either case, the government could be receiving a large amount of funds (from TIPS buyers or from retirees’ annuity premiums) that would represent contractual obligations to make long-term inflation-indexed payments. For example, in a universal system, funds backing annuities funded with 2 percent of workers earnings could amount to about 15 percent of GDP when the system is fully mature. A key question for policymakers is, “how would the government manage (or spend or invest) the large volume of funds it received from TIPS buyers or annuity purchasers?”

#### **Insuring Insurers**

Currently, state governments have sole responsibility for regulating insurance companies and guaranteeing their solvency. If federal law requires or encourages retirees to buy annuities, it might also be expected to guarantee the solvency of the insurance companies that have made long-term commitments to retirees. How that solvency guarantee would be organized is an important question. Would it resemble the Pension Benefit Guaranty Corporation, or the Federal Deposit Insurance Corporation, or other federal models?

#### **Recap of Annuity Choices**

The design of retirement payout rules will confront inevitable tension between offering choice and providing security. Hard and fast rules might ensure some level of security, but will also create pressure for exceptions. As accountholders approach retirement, they will face choices such as:

- (a) Whether to buy a life annuity at all;
- (b) How much of one’s account to spend on a life annuity;

- (c) Whether the annuity would be indexed for inflation;
- (d) When to buy a life annuity;
- (e) Whether to buy a guarantee feature and, if so, what kind;
- (g) If joint-life annuities are optional for unmarried retirees, whether to buy one and with whom; and
- (h) If joint-life annuities are offered or required for married retirees, which type to buy and what level of benefit to provide the secondary annuitant.

Decisions on these questions will have lifelong consequences. To the extent that retirees have choices, it will be important that they receive advice and assistance to understand the consequences of different courses of action for themselves and for the well-being of their spouses, dependents, and potential heirs. Organizing and paying for trustworthy advice could become an important issue in a new system that envisions many choices in the purchase of life annuities.

Finally, in the realm of consumer education, there is a risk of confusion about what we mean by "annuity." Two different products are called "annuities" and they are very different. *Deferred annuities* are investment products, not insurance. Only *life annuities* guarantee payments for life. Deferred annuities are far more common and more actively marketed by financial advisors, brokers or agents. In recent weeks, a few news reports have pointed to problems in the marketing of deferred annuities to seniors, who end up losing part of their life savings because they bought products that were not appropriate to their circumstances. (Morgenson 2005, Kirchheimer 2005).

Sources:

Reno, Virginia P., Michael J. Graetz, Kenneth S. Apfel, Joni Lavery, and Catherine Hill (eds.), (2005). *Uncharted Waters: Paying Benefit from Individual Accounts in Federal Retirement Policy*, Study Panel Final Report, Washington, DC: National Academy of Social Insurance.

Morgenson, Gretchen, "Who's Preying on Your Grandparents?" *New York Times—Business Section*, Sunday, May 15, 2005

Kirchheimer, Sid, "Deviled Nest Eggs," *Consumer Alert, AARP Bulletin*, June 2005.

---

Chairman MCCRERY. Thank you, Ms. Reno. We have, we think, one vote on the floor. We are going to run over to the floor, vote, and come right back. The Committee will be in recess until we return.

[Recess].

Chairman MCCRERY. The hearing will come to order. Thank you all for your patience. We are glad to be back to ask you a few questions about your testimony, which was excellent. We appreciate very much your being with us today to share those views with us. Mr. Pollock, I appreciate your thoughtful approach to establishing personal accounts using the Social Security surplus. In your proposal, you recommend having workers initially invest in inflation-indexed Treasury bonds. Why do you recommend this particular type of bond? How large is the market now for that type of bond? Would having individuals invest solely in those specific forms of Treasury securities affect the market in any way?

Mr. POLLOCK. Mr. Chairman, I view the biggest risk to retirement savings to be inflation. Especially if you own straight bonds, if we should get into a situation of monetary expansion which results in inflation, it is a way to lose the real purchasing power of your savings. With the inflation-protected securities, you are automatically covered by the inflation indexation of the bonds against this single biggest risk. For decades, inflation-indexed securities have been promoted as the right idea by economists. They have been introduced by many countries including this country, during the nineties. They have been extremely popular. There are many mutual funds that offer them to the public, and they have been

welcomed by public investors. I picture the TIPS in personal accounts being a private placement, another similarity to what happens now with the trust fund. The bonds now are privately placed with the Social Security trustees. This would be a private placement into a personal account, so, there would be no need to sell the bonds, nobody would have to beg foreign investors to buy them; in the first instance, you wouldn't move the market.

I also recommend in my detailed comments that there be some restricted period, I suggest perhaps 5 years, where these couldn't be sold, just in case—I don't think it would happen, but just in case—there would be an outflow from the accounts that would be market moving. If you had a 5-year period, another advantage is that then these accounts would automatically buildup to a size where they would become economically easier to evolve into other investment opportunities if we wanted to at that point.

Chairman MCCRERY. Now, talk to us about the advantage—I assume you think there is an advantage—in issuing these Treasury securities in the names of individuals, as opposed to simply issuing Treasuries to the Social Security Trust Fund. Expound upon that.

Mr. POLLOCK. I think the single most important advantage, Mr. Chairman, is that it is a philosophical advantage, as I said in my testimony. It is consistent with the deep and extremely important trends in American political philosophy of trying to create widespread ownership throughout American society, where the ordinary citizen is an owner of property as part of the American social miracle. This plan would promote widespread ownership of retirement savings, as I said before, just as we promote widespread home ownership. So, I think there is a huge advantage in the fundamental philosophical message we are giving.

Now, from the individual's point of view, you are, in addition, gaining an absolute obligation of the government, a true right, in exchange for the very large amount of money you are giving over to the Social Security system, as opposed to a future political formula which may or may not be there. As we know from public surveys, a very large number of people, especially young people, simply don't believe they will ever get money from Social Security. We can say that the citizen knows that if all you do is raise taxes to pay Social Security benefits, net, you haven't done anything but taken money and given it back. So, this plan would establish a true obligation; you would own a U.S. Treasury bond. I go on in my detailed testimony—and I can comment if you want me to, Mr. Chairman, as to how that might further link to actually decreasing the long-run Social Security deficit, which I think it could do in an efficient way.

Chairman MCCRERY. So, I believe you are saying, Mr. Pollock, that by taking an equivalent amount in Treasury bonds—an amount in Treasury bills equivalent to the amount of the cash surplus in Social Security, and putting those in the names of individuals, you are at least protecting, for those individuals, that surplus to be paid as part of Social Security?

Mr. POLLOCK. Yes, sir. You are protecting it by making it into a real Treasury obligation, a real asset that they actually own.

Chairman MCCRERY. Thank you. Dr. Mitchell, you and other members of the President's Commission to Strengthen Social Secu-

rity concluded that it would be reasonable to establish personal accounts along the lines of the Federal Thrift Savings Plan. Why did you use the TSP as a model?

Dr. MITCHELL. We used the TSP as a model for several reasons. One is, it is very clear, efficient and low cost; as was testified to by Mr. Purcell earlier today, the fact that it has large scale means that it is quite inexpensive to offer. Also, the fact that it has relatively few investment choices, a reasonable array—I would personally add, probably, a lifecycle fund, maybe a TIPS fund—but a reasonably small number of funds, makes it inexpensive. Also, the fact that the plan is fairly well communicated, fairly well understood, it has been around a long time, and it seems to have some history behind it offers an example of how it might work.

Chairman MCCRERY. Thank you. Mr. Cavanaugh, in your testimony, you talk about the administrative expenses being, perhaps, very high if we were to try to go to personal accounts in Social Security; and you back up your assertion by pointing to administrative expenses of small 401(k) plans, small defined contribution plans, and, particularly, small employer plans. While I think what you say is true in terms of the cost of those plans, I am not sure how that is relevant to establishing personal accounts in Social Security. After all, the Social Security system itself is kind of like a big 401(k) plan. There are personal contributions collected by the employer and sent to the central government. What most personal account proposals propose is for basically the same thing to happen, except instead of the money—all the money going into a central pot, it goes into individual accounts, which as we heard in testimony from the SSA this morning—the SSA seems to indicate that we have the capacity to do that at a much lower cost than you have estimated. Do you want to comment on that, and maybe clear that up?

Mr. CAVANAUGH. Yes. What you are saying, I think, was what many people in the 401(k) industry believed a decade or so ago, because they had already got all the business they could get from large corporations where everybody had a 401(k). So, they started to try working with smaller businesses and bringing them in, to provide them the services, and they had the notion that they could get economies of scale. I think they did a great job. They bring in businesses, some not too small, and some of the smaller ones, and they get thousands of them into their computerized system, and that way they get the economies of scale, just like the TSP.

But, what they find is that in order to do this, they have to deal with each one of these businesses and their employees. You have to go in there and explain the plan document. You have all sorts of explanations of different investment options; and you have a fiduciary responsibility to make sure that you don't give investment advice, but at the same time you give information. It is a very tricky business. It requires professional people to do it, and that is why they can't do it for less than 3,000 bucks a year, even though they have these tremendous economies of scale that they have achieved over the last 10 years and fierce competition.

The difference between that and the TSP is, the TSP is just one employer, the government, not five-and-a-half million. The first thing I did when I started the TSP was to announce that, Hey, I

am a wholesaler, I am not going to do the retail. I left it to the Federal agencies and their field offices all over the world to do the face-to-face; the consultation, the advice, and all that sort of thing, passing on the forms, helping people fill them out.

Congress required that Office of Personnel Management train trainers in every Federal agency for this purpose, a very demanding task. So, they did the retail for me. They had systems in place, they had the computers, they had the payroll offices. Small businesses have none of that, and that is fundamentally why you just can't reach them. Sixty percent of businesses in the United States have less than five employees, which means the cost, or expense ratio, would be twice what I testified on. You can't get there from here.

Chairman MCCRERY. Couldn't we address some of those concerns, though, in a different way from the 401(k) model? Since this is going to be basically a government-administered plan, as was suggested by Mr. Lockhart this morning, the SSA itself could play a role in educating workers as to the choices in their Social Security account. Couldn't we relieve that burden from the small employers?

Mr. CAVANAUGH. Yes. I think politically, as well as a practical matter, virtual guarantees have been given to small business: You are not going to have to do anything more than what you are doing now. There are two problems there. What they are doing now, while adequate for the purposes of the Internal Revenue Service (IRS) and the SSA, is totally inadequate for an investment function when the SSA cannot reconcile \$10 billion a year to individual accounts. You can accept that in Social Security because of the way they credit the benefits; you cannot accept that in a financial institution. I balance the TSP to the penny every day, and that is the way banks have to operate. So, the information system is just totally inadequate.

When you talk about alternatives—of course, in my testimony, I was focusing, as I said, on the Administration's plan, which is the 401(k)-type structure, there is little difference between the two. I think the reason why you find very few proponents of alternatives like Individual Retirement Accounts (IRAs), Great Britain and Chile stumbled doing that sort of thing, is because you have millions of people out there that are financially unsophisticated, at the mercy of a whole bunch of financial institutions. Certainly in the United Kingdom they learned never to do that again.

Chairman MCCRERY. Right.

Mr. CAVANAUGH. So, then you get into Simple IRAs, which some small businesses use, but they require employer contributions, which a little business just can't handle. So, what you get down to is—even though you say to small businesses, you don't have to do any more than what you are doing—what they are now doing is inadequate for investment purposes. Second, if they are not going to do the normal employer functions in a 401(k), who is going to do them? I can take you through the traces on it. You wind up with a 401(k) provider having to do them, people like Fidelity Investments, and T. Rowe Price, and Vanguard, and all those people; they will go in and they will do them for you as they have been trying to do. They will come out with the same economics. You still

have to pay 3,000 bucks a year—more, actually, than that, because right now the 401(k) industry has pushed the frontier, getting into more and more businesses, and some smaller ones. Beyond that it is a jungle which they can't penetrate; little tiny businesses, you just can't deal with them. So, you would be back in the hands of the 401(k) providers, God bless them, but you can't ask them to do it without a government subsidy.

Chairman MCCRERY. Well, it seems to me it is kind of apples and oranges when we are talking about a central government system and lots of 401(k)s. I understand. I get your—one of your points that the educational process would be difficult, but I don't know that it would be so difficult that we couldn't do it if we managed it correctly. Do any of the other panelists have a thought on this subject? Mr. Cavanaugh has brought up something that is provocative. Mr. Pollock.

Mr. POLLOCK. Mr. Chairman, I think one of the advantages of the sort of plan that I was proposing, which is the creation of book entry government securities, is that it solves a lot of the administrative problems. It makes a purely book entry, computerized system, possible, which would have very low costs, even granting the existence of problems at Social Security, which Frank brings up. A second reason is that, as an education project, it is exceptionally simple. It is essentially the same as acquiring savings bonds. I think if you explain to the American people that this is in exchange for part of your Social Security; and I stress the "part," because we are talking about the surplus. We are not talking about disability insurance or the other welfare aspects of Social Security; we are talking about the savings aspects of Social Security. For that we are creating an actual savings program, which looks just like a payroll deduction, to acquire a savings bond. In particular, it looks like an I Bond, which is an inflation-indexed savings bond. People will understand that, and I think they will like it very much.

Chairman MCCRERY. Mr. Purcell.

Mr. PURCELL. I think I agree with both Mr. Pollock and Frank Cavanaugh. You certainly could have a low-cost system of individual accounts, one that is essentially invisible to the employer, they would do nothing more than they do now. However, that system would not look like the TSP. The fundamental roadblock is that, although, as was testified earlier today by Mr. Lockhart, more than 60 percent of W-2s are submitted electronically, more than 70 percent of employers submit W-2s on paper. Four out of 5 employers in the United States have fewer than 10 employees. They could eventually do all of that electronically; maybe in 10 or 20 years, and then it will be very easy, relatively easier, to design a system that somewhat resembles the Thrift Plan.

Today, you have employers submitting large blocks of tax money to the local Federal Reserve Bank, which consists of both income tax withholding and Social Security taxes. The Federal Government doesn't know how much of that money is payroll tax and how much is Social Security tax, much less how much is mine versus a co-worker, until the employer files the W-2 once a year. That is what slows things down. You can't allocate those taxes into specific investments until you know how the employee wants to invest it; and if that is done on paper, it is going to be done very slowly.

So, you could have a system that is built entirely on the current payroll tax structure, but you are going to have a delay; and the current delay, according to the SSA, could be 7 to 22 months in getting a worker's payroll tax into the account that they choose to put it in. They will probably have the opportunity to redirect that investment from the bond fund to the stock fund once a year. They wouldn't be able to log onto a Web site and monitor their account daily and redirect their investments; that is what you can do with the TSP. So, it is simply -it is not a matter of, Can it be done? Certainly it can be done. There will be tradeoffs between choice and control by the participant, versus cost borne either by the employer or through a government subsidy.

Chairman MCCRERY. Bear in mind that carving out part of the payroll tax is not the only way to fund personal accounts. So, don't get caught in that trap that everything has to be in that universe. It doesn't. There could be default options until the employee's paperwork was received by the Federal Government. So, I think, again, we can get around those—

Mr. PURCELL. I agree completely. It is simply a matter of the public understanding that this is what it will look like, and is that okay with you. If it is, it will work.

Chairman MCCRERY. But, mechanically, and from a cost standpoint, I still believe we can solve those problems without the kinds of administrative expenses Mr. Cavanaugh is talking about. Ms. Entmacher.

Ms. ENTMACHER. I did want to point out that if the accounts are supposed to be divisible at divorce, that is, the contributions that are made during the course of the marriage are supposed to be divided at the time of the divorce, there would be additional information that would need to be collected throughout about marital status. The timings of contributions would have to be related to the information about marital status. The contributions during marriage would have to be segregated from the amounts that were in the account prior to the marriage, which would be separate property. Then, you sort of start looking at, okay, what goes in during the marriage and what are the accumulations on that; and if that is the divorce division that is planned for, then you would have to know that from the front end, and plan for it.

As I say, there is no system that currently does that. The TSP doesn't do it. We don't have a national registry. There is no national center that collects this information, even on a statistical basis, much less with respect to individuals. There would, quite frankly, be concerns if the Federal Government said, Okay, we are going to start collecting information about the marriages and divorces of all Americans—confidentiality issues. So, I think that—this is why so many of these payout issues have to be confronted at the front end, because you might say, Well, that is what we are going to do and then discover you don't really have enough information to implement a fair division of accounts.

Chairman MCCRERY. Why couldn't the personal retirement account be an asset like any other asset in a divorce, and have the court decide how it is divided and communicate that to the SSA?

Ms. ENTMACHER. Well, that is an extremely expensive way of doing it for the individuals. What happens today with many of

those assets is that people who are not represented by lawyers don't get a fair share. I think what most people don't realize is that in a majority of divorce cases, at least one person is not represented by a lawyer. So, it is going to be very haphazard whether anyone would get a share of an account. It is particularly troubling because we don't know how much benefits might be reduced because a spouse contributed to an account. So, leaving it to a court to decide—plus you would get different results all over the country. Some States have community property, some States don't.

Chairman MCCRERY. You get that now, though, with assets.

Ms. ENTMACHER. Yes, and it results in a lot of women not getting a fair share of assets at the point of divorce. If we are talking, again, not about accounts that supplement Social Security benefits, but that are designed to replace them, we are talking about the core benefit, the benefit that people rely on to stay out of poverty—not a supplement. We are talking about the bottom half of the income distribution. The 401(k)s and IRAs held mostly by higher income people. This is the basic tier of retirement income, so, it is especially important to make sure that women get a fair share.

Chairman MCCRERY. I don't disagree with you, but, couldn't we—in order to cut through some of that disparity from State to State, jurisdiction to jurisdiction, overlay a Federal requirement with the disposition of these accounts so that the court would have to take into account the Federal requirement, and make that part of the judgment?

Ms. ENTMACHER. Well, but the issue has to come to the attention of the State court, and figuring out—what does that mean? Do you—if you are not a community property State, do you use community property principles to divide the account? Where do you get that? You then have to turn to the SSA, or the TSP, or whoever is administering the accounts for information and say, "Okay, tell us how much money went in during the course of the marriage and what were the accumulations?" The information still has to be generated by somebody for the court to do that.

Chairman MCCRERY. Well, again, I agree with you that there are complications, and believe me, we have looked at these. I think there are ways to work all those out to provide the maximum amount of protection for both spouses. You make some good points, and we need to pay attention to that.

Ms. ENTMACHER. Thank you.

Chairman MCCRERY. Mr. Levin.

Mr. LEVIN. I will get back to the TSP. Let me just ask you, Mr. Pollock, right now we have a Social Security system that is progressive, right, replacement rate differs according to income? Under your approach, that would not be true?

Mr. POLLOCK. Under my approach, the progressivity would remain the same.

Mr. LEVIN. How is that?

Mr. POLLOCK. It remains the same because, as is explained in my detailed submission, Congressman, in exchange for getting TIPS that you actually own in your own account today, you give up an equivalent value of future benefits; that is, economically you must do that, that is your choice. The future benefits, what I call the "exchange rate" between the future benefits and the TIPS



today, have built into them, and into the exchange rate, all of the formulas which govern Social Security benefits. So, the result of all of that progressivity stays exactly the same.

If I may comment further, Congressman—suggest that if we want to use this promotion of ownership and creation of real assets in exchange for Social Security payments, we want to use that, in addition, to reduce the deficit, we could make that exchange rate itself more progressive; that is to say, for higher income people you would give up more than a dollar's worth of present value of future benefits for a dollar today. It is my belief that since higher-income people doubt very much that they will ever receive the scheduled benefits, they would choose to go into the program.

The result—excuse me, if I could just finish the thought. The result would then be that in addition to creating ownership and true assets, we would also be reducing the Social Security actuarial deficit. The liabilities of the Social Security program would be falling faster than the odd assets in the trust fund, and its finances would be improving.

Mr. LEVIN. Indexing into it, you are suggesting—I don't know what you mean by "higher income." Let's suppose that everybody with 20,000 and above was classified as higher. Disability would be separated out?

Mr. POLLOCK. Congressman, in all of my mathematical work on this, I start by excluding the disability insurance program, dealing only with OASI, because disability insurance, by definition, is insurance—you must commingle funds to have insurance work.

Mr. LEVIN. Survivor benefits?

Mr. POLLOCK. Is the same. I think there is a little confusion, if I may say so, when we talk about creating personal accounts or personal lock boxes, because people tend to characterize all of Social Security as one thing, whereas, in fact, Social Security is two quite different things.

Mr. LEVIN. Okay. I just have limited time.

Mr. POLLOCK. I am sorry. You agree with that point, though, I think, Congressman, that it is part insurance or a welfare program and it is part a savings program.

Mr. LEVIN. I wouldn't call it a welfare program. I think the public—you size up the public very incorrectly, I think the public has spoken pretty loudly about personal accounts. It is interesting, we are spending a lot of time on the TSP, though what I think has been suggested in the last 24 hours doesn't involve TSP. So—and maybe they listened, Mr. Cavanaugh, to your admonitions about the complexity of it. There is plenty of complexity with this concept. I guess they are including two bonds and somehow an increase in solvency; we will see how they work out without taking general revenue moneys or making promises as to the future. We spent a lot of time on the TSP. It is in the President's plan; it is not, apparently, in this concept. Ms. Entmacher, just if you would, the greatest dangers you think of what Mr. Pollock has suggested are what?

Ms. ENTMACHER. I think the greatest danger is really embodied in this idea that it is an individual lock box. First he talked about, well, that doesn't apply to disability, and I wonder whether he is including the family disability benefits in that as well. Par-

ticularly women, when they reach retirement age and take benefits at 62 and above, many, many women rely on the higher benefit that they get as a spouse and as a widow. Millions of working women, women who work in the paid labor force, who have earned their own Social Security benefit, get a supplement that Social Security provides to spouses and widows.

Despite the fact that more women are in the paid labor force for longer periods of time, it is still the fact that they earn less than men and take more time out of the labor force. So, when they reach retirement, their income security really depends on the higher benefits that they get as spouses. What has been referred to as the individual savings component of Social Security—they benefit from the fact that it is not an individual savings component; it is a family savings component that protects workers and their spouses and surviving spouses. So, I think that is the biggest concern. We could, in a few years, see a return of the poverty rates, particularly among elderly women who already are the large majority of the elderly poor, to what they were back before Social Security was created.

That is my nightmare. When I look at the benefits that women will get under Social Security in the future, 40 percent of women are going to be receiving spousal benefits 40 years from now; they are still going to be relying on them. When I look at what women have in their 401(k)s and IRAs, it is 60 percent of what men have. They are still disadvantaged. So, if it is every man for himself in this brave new world, I worry. That is my biggest worry.

Mr. LEVIN. My time is up. Let me just ask Dr. Mitchell about the Hirschel Organization, and they would have to buy—what would keep them out of poverty? We are talking about 20, 30 years, right, for the average woman?

Dr. MITCHELL. Right.

Mr. LEVIN. Twenty or 30 years; we are talking about a long period of time. How do you calculate an annuity so that you are sure it will keep people out of poverty when you are not sure what the poverty level is 5, 10, 15, 20 years from now; how do you do that?

Dr. MITCHELL. Well, practically speaking, the poverty line in the United States is defined according to a real standard, that is, an inflation-indexed standard. So, what you would do, practically speaking, is compute the annuity that you would take from your personal account, make it an inflation-indexed annuity, add the traditional defined benefit pillar that you would still keep getting from Social Security, which is also inflation indexed, and if the two of those were projected to exceed the poverty line, which is also inflation indexed, then it would work out. So, technically speaking, it is easy to do.

Mr. LEVIN. I am going to ask you further questions, because the way that Social Security is now indexed, I think people would come out differently. I think it is difficult to calculate the annuitization so, it would really work, but my colleague is here, and so I may ask you to give us an answer for the record.

Dr. MITCHELL. If you could restate the question, that would help me, please.

Mr. LEVIN. I will do that.

Chairman MCCRERY. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman. Mr. Pollock, I appreciated your references to Jake Pickle. For those of us who served with him, nobody could more succinctly take care of an argument than Jake Pickle. Having said that, I think everybody at the table would agree, the President's plan really has gone nowhere. In fact, the numbers have gone down the more time he spends trying to explain his proposal. As Jake Pickle would have said, "That dog won't hunt." Why is the President having such difficulty in getting traction with his plan?

Mr. POLLOCK. Congressman, I would prefer to answer that question by saying, how can we improve the plan? I think the way to improve it is to make it exceptionally simple and easy to understand. The objections to the President's plan, as I read them, have been, first of all, it is risky. We are going to invest in equities. People have compared investing in equities to gambling in Las Vegas and so on. Second, people say it will be exceptionally expensive to operate. I am speaking of administrative costs. Thirdly, they say you are going to take this cash away from the Treasury, and—have to borrow it from Asian central banks or something. There is a fourth objection, which is that people will be confronted with confusing and complex decisions that they don't wish to make, and Wall Street will be all over them with dozens of options and things.

I think if we had a simple plan, which had none of these problems, which doesn't suggest to people they will be in Las Vegas with the equity market, that they are not obliged to make confusing and difficult decisions they don't wish to make, that the administrative costs are very cheap, and that it doesn't deprive Treasury of any money, they would like it a great deal. At least that is my bet, as I said before.

Mr. NEAL. Thank you. Dr. Mitchell, you indicated during your testimony that you thought that private accounts would be a good idea based upon a very limited number of opportunities to invest?

Dr. MITCHELL. Correct.

Mr. POLLOCK. Mr. Chairman, may I be excused?

Mr. NEAL. Feel free to disagree with this, but I must tell you, having been here the last 17 years, the same people in this Congress who are suggesting that there be a limited number of opportunities to invest, that they all be safe, anybody who knows how Washington works—that if we were sitting here five or six years ago with the dot-coms, that same chorus would be yelling to put that money in riskier investments. Do you know what? In this Congress there would be a sympathetic ear for trying that. Now, I try to remind people for those of us who were here during the Savings and Loan difficulty, that that is precisely what happened. You will not be able to rein in this Congress on the issue of safe investments. Feel free to comment or disagree and maybe suggest how you would argue that we would do it then. I think you know of what I speak.

Dr. MITCHELL. I can answer on two fronts. As you know, in the private pension arena, defined contribution plans are required to have a minimum of three options, and typically you find a stock index fund, a bond index fund, and some sort of a cash money market fund. Moreover, in the private sector you will typically find employers putting employees into a default. If you choose not to

choose, then we are going to put you in something. It has been a money market in the past, or slowly but surely, life-cycle funds are growing in popularity, where you start out, maybe, a little bit riskier; the older you get, you move into a more conservative account.

When we were talking on the Social Security Commission in 2001, we grappled with the issue of cost versus choice in great detail. What we proposed was that nobody should be allowed to buy a single company stock. I think with Enron and World Com and Tyco, in everybody's minds that simply would not be permissible. These would have to be indexed accounts, so that you wouldn't be able to pick just high-tech or just low-tech, but you would have to diversify. I really like the idea of life-cycle. I think you are right, most people don't have the time, the energy, or perhaps even the education to go and decide how to allocate their portfolios, day in and day out; plus they probably shouldn't be doing that. So, one thing we have seen, for example, is that countries all over the world that have defined contribution plans have moved to life-cycle funds.

Mr. NEAL. Do you think there is some validity to the point that I raised about the safeguards that have to be built into this? Only because, given that S&L issue, when one tracks what happened, it is very simple to conclude that people got into doing that business when they shouldn't have been in. We have deregulated that industry, no questions were asked, and the disaster awaited the American people. I am very concerned that if this is not meticulously addressed, we run the risk of having the dot-com industry drive retirement arguments around here. Maybe I can go to Mr. Cavanaugh for a second, Mr. Chairman, if I could. I know my time has expired. Mr. Cavanaugh, could you talk about how difficult it would be to administer a series of small accounts?

Mr. CAVANAUGH. You want me to talk about the difficulties in administering?

Mr. NEAL. Yes.

Mr. CAVANAUGH. Well, the problem is, 60 percent of businesses have less than five employees; they don't have personnel offices and payroll offices. As Mr. Purcell was pointing out, 72 percent of them are reporting on paper; they are not electronic. They don't have the education, and they have been virtually assured by the Administration, as I understand it, that they wouldn't have to do any of the things that employers in 401(k) plans do. They just can't do it. They don't have the education. We are talking about people that cut your grass and cut your hair and run the local garage and beauty salon and whatever. These are not institutions that can handle complex financial matters. The industry—this is not speculation—is trying to get in there, the 401(k) industry and get these people signed up, and they find they just cannot do it at a low enough cost. There are too few people to spread the administrative expenses over; it just doesn't work.

Mr. NEAL. Thank you. Thank you, Mr. Chairman.

Chairman MCCRERY. Thank you, Mr. Neal. Mr. Levin, do you have anything else?

Mr. LEVIN. No, thank you very much.

Chairman MCCRERY. Yes, thank you all very much. Mr. Pollock, by the way, told us prior to the hearing that he had to leave at 12:45. He was not upset with anyone at the witness table or, I don't think, with the Members.

Mr. LEVIN. Can I just say that Mr. Pomeroy isn't here because of a Base Re-Alignment Commission commission hearing in his home State. He wondered where he should go, and I said it is your judgment, but we understand if you decide to attend a base closing in your home State. Congresswoman Stephanie Tubbs Jones had an emergency she had to take care of, that is why she is not here.

Chairman MCCRERY. Thank you for that information. Thanks, once again, very much, and the hearing is adjourned.

[Whereupon, at 12:50 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

#### **Statement of Robert L. Clark, Dillingham, Arkansas**

Mr. Chairman, thank you for the opportunity to provide written testimony to the Committee on the need for enhanced financial education for American worker in order for them to better plan for their retirement income.

Throughout our economy, more and more American workers are being required to assume greater responsibility for their own retirement saving. The continuing trend toward greater use of defined contribution plans means that a larger proportion of the labor force must make key decisions on whether to participate in employer-provided pension plans, how much to contribute to these plans, and how to invest plan assets. The changing nature of defined benefit plans allowing lump sum distributions and the conversion of traditional defined benefit plans to cash balance plans are providing more options for workers as they change jobs and have the opportunity to access pension funds. Plan terminations and reduced generosity of existing plans mean that workers must decide whether to increase their own saving in voluntary supplemental retirement plans offered by their employers or in their own private savings plans. Adoption of individual accounts in conjunction with other Social Security reforms will further extend the choices individuals face in planning for their retirement and increase the responsibility that each of us has for our own retirement income.

Financial education and a comprehensive understanding of investment options are necessary if workers are to successfully achieve their retirement objectives. As public and private pension systems shift more responsibility to individuals, who bears the responsibility for providing an appropriate level of financial knowledge to American workers? Is it the responsibility of each worker to acquire sufficient knowledge to make appropriate saving decisions? Should firms that offer retirement plans be required to provide financial education programs for their workers? If in the future, Social Security offers workers the option of placing a portion of their contributions into personal accounts and deciding how these funds will be invested, does the Federal government bear some responsibility to provide adequate financial knowledge to Social Security participants so that they can make informed choices?

Available survey data indicates that many workers lack the required knowledge to determine how much to save each month to accumulate the desired level of income in retirement. In addition, they lack basic information on how to invest their retirement funds. The challenge for workers, firms, and the government is how can the level of financial literacy be improved so workers have the needed information to successfully plan for retirement in the coming years.

#### **Employer Pensions and Private Savings**

If individuals have insufficient knowledge concerning the saving process, they are unlikely to be able to make optimal retirement plans. A lack of financial education may result in workers starting to save too late in life and saving too little to reach their retirement goals. As a result, they are unlikely to achieve the desired balance between consumption while working and consumption in retirement. In addition, a lack of information concerning the risk-return distribution of various investments might lead workers to misallocate their retirement portfolios.

In a series of recent papers, my co-authors and I have examined the response of individuals to participation in retirement education seminars. Our research has shown that financial education can produce significant changes in how individuals think about and plan for retirement. In financial educational programs, workers

may learn that they have based their desired retirement age and income in retirement on insufficient saving and investment behavior. After participating in educational programs, many workers tended to revise their goals and concluded that they wanted to alter their savings behavior.

Individuals with low desired retirement ages often reported that they raised their expected retirement ages based on the information provided in the seminars. In addition, participants that entered the seminars with low retirement income goals tended to increase their retirement income targets toward a level more consistent with having retirement incomes similar to their net income while working. Many workers decided to alter their retirement saving behavior and planned to open new retirement savings plans and increase contributions to existing plans.

Another important finding is that plans for changes in retirement savings made during the seminar were not immediately acted on by many respondents. Whether due to inertia, myopia, or changed circumstances, many participants who expressed a desire to change their savings behavior at the time of the educational program failed to do so in the months following the seminar. Thus, it would be useful if participants in such programs are offered the opportunity to change their contributions to retirement plans at the conclusion of educational programs so that they can immediately institute their desired changes.

Our results indicate that there are significant differences in the reaction of individuals to the information presented in the seminars. Younger workers were more likely to indicate that they planned changes in their retirement savings as were women and participants in clerical and blue collar positions. Further research is needed to explore the actual responsiveness of participants to educational programs, the reasons why desired actions are not taken, and what policies would increase the link between desired changes in retirement plans and the actions necessary to achieve new retirement goals.

The results of our studies are interesting and have direct policy implications for plan sponsors and workers. The analysis indicates that financial education matters and ignorance is not bliss in the area of retirement planning. Quality educational programs encourage workers to reassess their retirement goals, to make more realistic plans, and to change their behavior in order to achieve their objectives. Follow through on plans made during a seminar remains problematic and introducing methods for immediate action would be useful additions to educational programs. Employees, employers, and appropriate government agencies should consider how to enhance the financial knowledge of American workers so that they will be better able to handle the increasing responsibility for their own retirement savings.

#### **Implications for Personal Accounts in Social Security**

Surveys of Americans reveal a dearth of financial knowledge. The lack of understanding of financial mathematics, investment options, and the level of savings needed for an adequate retirement income means that many Americans save too little, start too late, and are unaware of the implications of their actions for their standard of living in retirement. As life expectancy increases and employer pensions place more responsibility on workers for their own retirement income, the state of financial education becomes more important. The inclusion of individual accounts as a component of Social Security further enhances the importance of developing financial education programs for working Americans.

Inadequate financial education will have adverse affects if workers are offered personal accounts as part of Social Security. Workers who do not understand risk and uncertainty, financial mathematics of compounding, and expected rates of return to investment choices are likely to make poor decisions concerning the use of personal accounts. If Congress chooses to enact Social Security reforms that include personal accounts, I believe that Congress should develop financial educational materials and programs that provide appropriate information for American workers. Such materials should help them make the best choices within a future Social Security system.

This financial information and education should be unbiased and provide a clear picture of the investment choices. With such information, workers can choose to allocate a part of their contributions to these account and make appropriate investment choices that will maximize their retirement income or to refrain from selecting this option. Without such education, many workers will make poor choices based on inappropriate or bad information. As this Committee considers Social Security reforms, I recommend that you include as part of your deliberations how to provide high quality financial information and education to workers so that they will be able to adequately deal with the new environment.

The research showing that individuals respond to employer-provided financial education by altering their retirement goals and private savings behavior has impor-

tant implications for Social Security personal accounts. Results of my research studies are reported in the publications cited below. Thank you for this opportunity to discuss with you the importance of financial education and its impact on retirement savings.

#### Research Papers on Financial Education

Clark, Robert and Madeleine d'Ambrosio. July 2002. "Saving for Retirement: The Role of Financial Education," TIAA-CREF Institute Working Paper 4-070102-A. Published on-line in *Retirement Implications of Demographic Family Change Symposium*, Society of Actuaries, <http://www.soa.org/library/monographs/retirement-systems/m-rs-2-tableofcontents.html>.

Clark, Robert and Madeleine d'Ambrosio. 2003. *Ignorance Is Not Bliss: The Importance of Financial Education*, TIAA-CREF Institute Research Dialogue No. 78.

Clark, Robert, Madeleine d'Ambrosio, Ann McDermid, and Kshama Sawant. 2003. "Financial Education and Retirement Savings." Paper presented at *Sustainable Community Development: What Works, What Doesn't and Why*, a conference sponsored by the Federal Reserve System. Washington, March 2003.

Clark, Robert, Madeleine d'Ambrosio, Ann McDermid, and Kshama Sawant. 2004. "Sex Differences, Financial Education, and Retirement Goals" in Olivia Mitchell and Stephen Utkus (eds.), *Pension Design and Structure*, Oxford, UK: Oxford University press, pp. 185-206.

Clark, Robert and Sylvester Schieber. 1998. "Factors Affecting Participation Rates and Contribution Levels in 401(k) Plans," in Olivia Mitchell and Sylvester Schieber (eds.), *Living with Defined Contribution Plans*. Philadelphia: University of Pennsylvania Press, pp. 69-97.

---

#### Statement of Craig Copeland, Ph.D. and Jack L. VanDerhei, Ph.D., Employee Benefit Research Institute

##### Individual Social Security Accounts: Administrative Issues

We are pleased to provide this written testimony on administrative issues within proposed Social Security reforms. All views expressed are our own, and should not be attributed to the Employee Benefit Research Institute (EBRI). Established in 1978, EBRI is committed exclusively to data dissemination, policy research, and education on financial security and employee benefits. EBRI does not lobby or advocate specific policy recommendations; the mission is to provide objective and reliable research and information. All of our research is available on the Internet at [www.ebri.org](http://www.ebri.org)

President Bush has made a strong push for the inclusion of individual accounts within the Social Security system. The inclusion of individual accounts brings forth many issues that are not currently present under the traditional defined benefit system structure of Social Security. While individual accounts have been debated heavily on its political attractiveness, the details of how the system would operate or the administration of the individual accounts have not been thoroughly discussed. However, the discussion on this issue has greatly expanded from the first time the Employee Benefit Research Institute focused attention on these administrative issues in their November 1998 *EBRI Issue Brief*.

The political and policy debate has been on going, but from a *practical* perspective, the debate so far has virtually ignored any specific considerations about how to administer such accounts. Any discussion of *whether* to create individual accounts must also address the basic but critical questions of *how* they would work: Who would run them? What would they cost? Logistically, in what form are they possible?

This testimony presents an overview of the most salient administrative issues facing the current Social Security reform debate—issues that challenge policy makers to carefully think through how their proposals could be implemented, in order to achieve their policy goals.

Speeches, media articles, books, and television reports have frequently suggested that if the federal employee Thrift Savings Plan can work, and if private employers can make 401(k) plans work, then individual accounts in (or in addition to) Social Security can be easily administered. There is a way to design a system of individual accounts that could potentially be administered in a cost-effective and timely way—but for a variety of inescapable reasons, that system most likely will bear little or no resemblance to a modern 401(k) plan. If a typical Internet-based 401(k) with easy access to account information and investment options can be described as the

“Porsche” of retirement savings plans, then the public should realize that a workable, cost-effective individual account within Social Security is most likely to look like a “Model T”:

- 401(k) plans typically offer an average of 14 actively managed investment choices (the ‘Porsche’ offers virtually unlimited options through ‘mutual fund windows’ and ‘self-directed brokerage accounts’), versus a very limited number (five for the Federal Thrift Savings Plan) of index investment options for a startup universal individual account system (probably one initially).
- 401(k) plans typically offer daily access through the telephone, and the ‘Porsche’ offers 24/7 internet-based self-management with immediate access to account information, updated daily, versus something closer to an annual account statement for a startup universal individual account system.
- 401(k) plans typically offer participants loans or hardship withdrawals from their accounts, with the ‘Porsche’ providing the ability to ‘do it yourself’ on the internet; a startup universal individual account system would likely find it impossible, setting aside desirability arguments, to offer either
- Workers’ 401(k) contributions typically come out of every paycheck, with rapid crediting to investment accounts; a startup individual account system tied to Social Security would involve ‘bulk’ contributions, with annual reporting of contributions to the Social Security Administration at the worker level, with crediting as much as 18 months later as the paper is processed. ‘Porsche’ 401(k) plans do both contributions and allocations on an every pay period fully automated basis. The startup individual account system could not, as a majority of employers file with the government on paper.
- 401(k) plans allow participants to modify their contributions regularly, with ‘Porsche’ plans allowing it 24/7 on the internet for next pay period implementation, versus a more likely once a year when the employee fills out their withholding form (per employer) for a startup individual account system.
- ‘Porsche’ 401(k) plans rely upon employers and administrators to be completely automated with computer interface of all data; a startup individual account system would have to allow employers to continue using pen-and-paper reports—as most currently do—if there was a desire to avoid high new employer administrative costs.

The issues and options in administering individual accounts raise concerns that cut across ideology. The object of this report is neither to dissuade the advocates nor support the critics of individual accounts. Rather, it is to bring practical considerations to a political debate that must ultimately deal with the pragmatic challenges of designing individual accounts that would not be too complex for participants to understand, nor too burdensome for small employers to administratively support, nor too difficult for a record keeper to administer, nor too expensive for low- and moderate-income participants to afford.

The major findings in this analysis include:

- **Adding individual accounts to Social Security could be the largest undertaking in the history of the U.S. financial market, and no system currently exists that has the capacity to administer such a system**. The number of workers currently covered by Social Security—the largest single entitlement program in the nation—is at least four times higher than the combined number of all active tax-favored employment-based retirement accounts in the United States, which are administered by hundreds of entities.
- **Direct comparisons between employment-based retirement savings plans and Social Security reform are difficult at best**. Social Security covers workers and businesses that are disproportionately excluded from employment-based plans. Because of these differences, a system of individual Social Security accounts would be more difficult to administer than employment-based plans, and total administrative expenses could be larger relative to benefits due to most employers not using automatic payroll systems, large numbers not using direct deposit, the vast millions of short service and young workers that are not included in either public or private employer savings plans, and the high relative cost of even one phone conversation with the holder of an account (commonly estimated to be an average of \$10 per phone conversation).
- **Credit-based systems such as the current Social Security program are less difficult to administer than cash-based systems, which must account for every dollar**. Inherent in the individual account debate is generally the presumption that individual account benefits would be based on cash contributions and investment returns. The current credit-based system tolerates small errors in wage reporting, because they rarely affect benefits. But every



dollar counts in a cash-based individual account system. To ensure that benefits are properly provided, an individual account system would require more regulation, oversight, and error reconciliation than the current Social Security program.

- **Social Security individual accounts cannot be administered like 401(k) plans without adding significant employer burdens—especially on small businesses.** Under the current wage reporting and tax collection process, it would take at least seven—19 months for every dollar contributed to an individual's account to be sorted out from aggregate payments and credited to his or her IA. This seven—19 month “float period” could result in substantial benefit losses over time. Options for preventing such losses involve difficult trade-offs, such as increased government responsibility, increased complexity, greater employer burdens, and/or investment restrictions for beneficiaries. Elimination of this “float period” by requiring faster action by small employers would lead to significant new administrative burdens and costs.
- **If legally considered personal property, the individual accounts of married participants could pose significant administrative challenges.** Social Security today must obtain proof of marriage only at the time spousal benefits are claimed. But some individual account proposals would require contributions to be split between spouses' individual accounts, requiring records on participants' marital status to be continuously updated to ensure that contributions are correctly directed. Also, dealing with claims on individual account contributions in divorce cases could place individual account record keepers in the middle of spousal property disputes.
- **The current body of knowledge is too uncertain, and in general the proposals to date are too vague, to make an objective estimate of how much an individual account system would cost to administer or whether it would succeed in accomplishing its policy goals.** Uncertainty exists over how individual account proposals would address key policy areas affecting administrative cost and complexity, how administrative costs operate in the current employer-sponsored retirement arena, and how lessons from the employment-based system apply to Social Security reform. For instance, in July 2001 the Federal Retirement Thrift Investment Board terminated and sued a contractor for failure to design a workable administrative system after nearly three years of effort. Given the relatively small size of the Federal Thrift Savings Plan (less than 3 million participants) compared with the total U.S. workforce (more than 148 million), a great deal could be learned by policy makers from this apparent system upgrade failure.
- **Individual account benefits would be highly sensitive to administrative costs, according to results using the SSASIM policy simulation model.** Workers born in 1976 and 2026 would receive between 14 percent and 23 percent lower total benefits under high administrative cost assumptions<sup>1</sup> than under low-cost assumptions, indicating that additional research on administrative costs is essential to assessing how—or whether—IAs could achieve the lower-cost assumptions. Proposals to use a flat percentage administrative charge could approach the lower-cost assumptions if the system had a s

---

#### Statement of Paul A. Cyr, Greene, Maine

Thank you for giving me this opportunity to write to you.

I am fifty-eight and a half years old and I work for the state of Maine Department of Transportation as a Highway Worker II. My job is driving truck—winter and summer. And when I am not actually driving I am doing heavy physical work. I've worked for the state of Maine for approximately ten and a half years. The first three and a half years were as a Highway Worker I. The job was mainly flagging for eight to ten hours a day, and at forty—seven years old it wasn't easy standing on hot top all day or being out in 10 below zero weather. While doing this job I've had the driving public swear at me for holding them up for three minutes, or people going by and hollering at me to get a real job. There have also been numerous times when I was almost hit by cars and in some cases the drivers actually laughed about it. I took the insults and obscenities thinking I would just do what I had to and it

<sup>1</sup>For further details about these points, see “Individual Social Security Accounts: Administrative Issues.” EBRI Issue Brief no. 237, September, 2001. ([www.ebri.org/publications/ib](http://www.ebri.org/publications/ib))

would pay off in the long run—that when I retired I would have a pension from this job to go along with my social security.

Before I went to work for the state of Maine I was a sheet metal journeyman. I spent four years going to school at night to get my state license as a sheet metal worker. I worked for a company while going to school and stayed with them for approximately twenty-five years. After that I worked for another metal shop for about four years until they filed for bankruptcy. And then it was another metal shop company for three years until I was let go for supposedly not being able to keep up with the younger people. These companies had very few benefits—no pension, no paid vacations, no bonuses, some paid holidays, and some had very limited health insurance. During all those years I installed duct work in dirty paper mills, in buildings with asbestos, and out in the cold and heat. I was paying into Social Security during this time and thought I would have a SS check when I retired. I couldn't put money into savings for retirement because it took all I had to be able to get by and pay my bills.

Then after working with no benefits or pension all those years and being out of work for two years, I landed a job with the state of Maine. After being a state worker for seven years I went to a retirement seminar and learned about the GPO and WEP. I was very upset by what I was told, so I went to my Social Security office in Auburn, Maine. The person I spoke to told me I would lose about a third of my Social Security benefits because I worked for the state of Maine. To add insult to injury, she then told me that I should not have taken this job, but should have found work somewhere else! But as I told her, I had been out of work for two years when I got the job with the state and figured that with their pension and Social Security I would be able to get by when I retired. But now the way I feel they might as well bury me in my work clothes, because I'll probably be working until I die.

From what I see the future does not look very good for me. With taxes going up all the time, as well as the cost of living (gas, lights, insurances, etc.), I'll never have enough to make ends meet if I retire. Also, there has been a woman in my life for many years but we can't get married, because if we do and she draws any of my state of Maine pension after I die she will get penalized on her Social Security. And I won't do that to her. Why should she get penalized anyway?

In my opinion the GPO and WEP should be repealed. Just give me the money that I earned and put into Social Security over the years—all of it, no more and no less. And do not penalize my fiancée either. Please, please repeal these two unjust laws so people like myself that have worked so hard for so many years (four of which were serving this country in the military) can end our working days with dignity and a sense of self worth and accomplishment.

---

### Statement of Ike Jones, America's Community Bankers

America's Community Bankers ("ACB")<sup>1</sup> is pleased to submit this written statement in connection with the Subcommittee's eighth hearing on "Protecting and Strengthening Social Security." ACB commends Chairman McCrery and Chairman Thomas for their leadership in crafting social security reform legislation. ACB firmly believes that personal accounts should be a part of any social security reform legislation, and that a "Community Bank Option" should be available to workers under a system of personal accounts.

#### Personal Savings Accounts

The debate over creating a more solvent Social Security retirement system has gained momentum over the past few years, especially with the Administration putting the issue front and center. Because Social Security operates almost entirely as a pay-as-you-go system, it is highly sensitive to the dramatic demographic changes that are increasing the average ages of our population. Increased life expectancies mean more retirees collecting benefits for more years. The resulting decline in the ratio of workers to beneficiaries is pushing the system toward insolvency, and personal savings accounts may be one way to create a more secure Social Security system.

---

<sup>1</sup> America's Community Bankers is the member driven national trade association representing community banks that pursue progressive, entrepreneurial and service-oriented strategies to benefit their customers and communities. To learn more about ACB, visit [www.AmericasCommunityBankers.com](http://www.AmericasCommunityBankers.com).

For several years now, ACB has supported allowing workers the choice of investing at least a part of their Social Security taxes in personal accounts. This approach will give individuals greater control over how their retirement security funds are invested and can create a more solvent system. Social Security reform should give workers the option of relying on their community banks and the investment products those banks offer, including insured deposits, in addition to those investment options available on Wall Street.

#### **Community Banks Are Experienced Investment Advisers**

Community banks already offer a variety of retirement investments, including FDIC-insured Individual Retirement Accounts (IRAs), certificate of deposits (CDs), mutual funds and annuities. Because community bankers understand the creation of wealth and their customers, they are in an excellent position to help consumers choose appropriate investments for these personal accounts.

ACB believes that any Social Security reform should ensure that consumers have the option of seeking advice on their personal accounts from people they already trust—their local community banker.

#### **FDIC-Insured Accounts (the Community Bank Option)**

For decades, American workers have trusted FDIC-insured financial institutions with their retirement savings. As of the end of 2003, banks and thrifts managed \$246 billion in retirement funds invested in IRAs and Keogh plans.

FDIC-insured retirement accounts should be an option for workers choosing personal accounts. Workers of all ages could benefit from an FDIC-insured deposit option or what is now being called the Community Bank Option. Some workers, while wanting a greater return than the Social Security program currently provides, will be wary of investing all of their retirement funds in equities and other retirement products that carry much higher risk. For these workers, a long-term deposit account would be the most appropriate investment for all or part of the funds freed up under Social Security reform legislation to invest in personal accounts.

Certainly, as workers near retirement age, their tolerance for taking risks in the stock or bond markets will dramatically decrease. ACB believes that FDIC-insured accounts would benefit these older workers not only as a place to invest new funds, but also as a safe product in which to rollover funds from riskier personal account products.

In addition, FDIC insurance has given millions of American families the confidence for over 70 years that the money they deposit in banks will be there when they need it. Allowing FDIC-insured accounts as an option under Social Security reform would encourage workers to choose the personal account option and increase support for reform among consumers.

#### **The Facts Support FDIC-Insured Account Option**

Many Americans depend on FDIC and NCUSIF-insured IRAs as part of their retirement savings plans. According to a January 2005 report of the Employee Benefit Research Institute, American families had \$270 billion invested in FDIC and NCUSIF-insured IRAs as of the end of 2003. These funds represent 9 percent of all IRA assets.

In addition, a 2001 Federal Reserve survey of consumer finances showed that 12.3 percent of all American households held insured IRA deposit accounts. The survey also indicates that households in all age brackets rely on these insured accounts for retirement savings, not just households headed by older Americans. American workers should also have insured deposit accounts as an option under any program of personal investment accounts.

Age Distribution of IRA Accounts at Insured Institutions

Age of head of household	Percent of all households in each age group that have IRA accounts at insured institutions	For each age group IRA deposit at insured institutions as percent of total IRA funds
< 35	5.3	25.0
35–49	11.1	116.4
50–64	17.0	18.4
65–69	18.5	28.0

Age of head of household	Percent of all households in each age group that have IRA accounts at insured institutions	For each age group IRA deposit at insured institutions as percent of total IRA funds
> = 70	16.1	27.4
<b>All Ages</b>	<b>12.3</b>	<b>21.2</b>

Data were provided by Federal Reserve Board staff based on the 2001 Survey of Consumer Finances (the most recent survey available) published in 2003.

IRA accounts refer to all IRA and Keogh accounts, excluding IRA-SEPs and similar accounts maintained as part of an employer-provided retirement benefit.

Insured institutions include banks, thrifts, and credit unions.

IRA deposits refer to the sum of IRA account balances of all household members at all insured institutions used by the household.

### Community Bank Option Invests In Local Communities

Allowing investments in FDIC-insured accounts returns money to the local communities where taxpayers live and work. Community banks will invest these funds in their local communities by providing loans to local businesses, mortgage loans to families, education loans to students headed off to college, and in many other ways. If this option is adopted, it could result in reduced rates for these loans.

#### Increase Deposit Insurance

Providing a substantial increase in deposit insurance coverage for all retirement accounts would further enhance the community bank role. Currently, the FDIC provides up to \$100,000 of deposit insurance for the retirement accounts (e.g. IRAs and Keoghs) of a depositor in a bank. The shift in America from defined benefit plans to IRA and 401(k)-type savings has increased the burden on individuals to manage their own assets. Retirement assets often exceed the current \$100,000 coverage limit by substantial amounts. A substantial increase in FDIC coverage of retirement accounts would strengthen the viability of the insured deposit account option. And it is important to note, the FDIC is funded through assessments on banks and savings associations, not taxes.

### Conclusion

ACB strongly believes that FDIC-insured retirement accounts, or the Community Bank Option, should be available for workers choosing personal accounts. Workers of all ages could benefit from an FDIC-insured deposit option. Some workers will be wary of investing their retirement funds in equities and other retirement products that carry risk. For these workers, an FDIC-insured long-term deposit account would be the most appropriate investment for all or part of the funds freed up by Social Security reform.

### Statement of Renee Lancon, West Hills, California

Our community is proud of our strong work ethic. We believe in rewarding and supporting hard work and citizens who make contributions to our society. That's why our congressional delegation simply must support legislation (Representatives McKeon (R-CA) and Berman (D-CA) have introduced the Social Security Fairness Act of 2005 (H.R.147) to address the unfair cuts to the retirement benefits of public employees who have dedicated their lives to serving their communities and their country. I urge our Senators and Representatives to support legislation to address these discriminatory penalties for public service: Government Pension Offset (GPO) and Windfall Elimination Provision (WEP), and on the issue of mandatory Social Security coverage

Too much is at stake to ignore this common-sense legislation!

I have recently retired and was shocked to find out when I went to the Social Security Office last week that I cannot collect ANY of my spouse's Social Security OR my own earned Social Security!

I earned my own 40 quarters when I worked in jobs other than teaching and cannot collect my own! I also cannot collect on my husband's because I chose to spend my career teaching!!!

I also moved from one state to another to follow my husband's career and was not permitted to leave my "retirement" in the previous state, so have worked as a teacher since 1962, and retired recently and only have "credit" for 20 years of teaching! It is NOT enough to live on!!!

I was supposed to be able to collect \$500 a month IF I had not been a teacher!!!  
The Social Security would have helped enormously! I also help support two children, one of whom is handicapped!!!

This Offset is unfair, inequitable and discriminatory. Most teachers are women and this affects them enormously! We have a severe teacher shortage in Los Angeles and in many other places and this hinders our recruitment efforts even more!

And, the "pension" I do collect, I paid into!!! I also saved in a 403B. I did all the things that I thought would allow me independence after a long career of public service! But, NOW, I am on the brink of poverty after dedicating myself to teaching special needs children for almost 40 years!!!

Nine out of 10 public employees affected by the GPO lose their entire spousal benefit, even though their deceased spouse paid Social Security taxes for years. The WEP causes low-paid public employees who work both inside and outside the Social Security system to lose up to 60 percent of their Social Security benefits. The loss of these benefits may make some people eligible for poverty-based assistance, such as food stamps.

Please join

I have also attached additional information from National Education Association's (NEA)

On behalf of the 2.7 million members, we would like to thank you for the opportunity to submit comments on the Government Pension Offset (GPO) and Windfall Elimination Provision (WEP), and on the issue of mandatory Social Security coverage. We commend the Subcommittee for holding this important hearing on a matter of great concern to educators and other public employees.

NEA strongly supports complete repeal of the Government Pension Offset and the Windfall Elimination Provision, which unfairly reduce the Social Security and Social Security survivor benefits certain public employees may receive. We oppose requiring public employees to participate in Social Security. Our testimony will cover both of these issues.

#### **The Government Pension Offset: A Devastating Loss of Benefits for Widows and Widowers**

The Government Pension Offset reduces Social Security spousal or survivor benefits by two-thirds of the individual's public pension. Thus, a teacher who receives a public pension for a job not covered by Social Security will lose much or all of any spousal survivor benefits she would expect to collect based on her husband's private-sector earnings.

Congress and the President agreed in 1983 to reduce the spousal benefits reduction from a dollar-for-dollar reduction to a reduction based on two-thirds of a public employee's retirement system benefits. This remedial step, however, falls well short of addressing the continuing devastating impact of the GPO.

The GPO penalizes individuals who have dedicated their lives to public service. Nationwide, more than one-third of teachers and education employees, and more than one-fifth of other public employees, are not covered by Social Security and are, therefore, subject to the Government Pension Offset.

Estimates indicate that nine out of 10 public employees affected by the GPO lose their entire spousal benefit, even though their deceased spouse paid Social Security taxes for many years. Moreover, these estimates do not include those public employees or retirees who never applied for spousal benefits because they were informed they were ineligible. The offset has the harshest impact on those who can least afford the loss: lower-income women. Ironically, those impacted have less money to spend in their local economy, and sometimes have to turn to expensive government programs like food stamps to make ends meet.

NEA receives hundreds of phone calls and letters each month from educators impacted by the GPO. Many are struggling to survive on incomes close to poverty, fearing they will be unable to cover their housing, medical, and food expenses on their meager incomes. For example, consider the following stories:

From NEA member Frances in Louisiana:

*"My husband, a Baptist minister, passed away [in 2001] after paying Social Security for 42 years. At times we had to take a second loan on our home to pay the Social Security. Now, I had to pay back the loan, but discovered that I will not get benefits because I receive a small teacher retirement"*

From NEA member Stella in Colorado:

*"I am a 72-year-old widow. . . . I was happily married to the same man for 391/2 years. My husband was a World War II disabled veteran who worked and paid into Social Security for 50 years. . . . He passed away 11 years ago thinking I would be able to receive his Social Security and Veterans Widow pension. . . . But now I'm living in poverty."*

### **The Windfall Elimination Provision: A Shocking Loss of Earned Benefits**

The Windfall Elimination Provision reduces the earned Social Security benefits of an individual who also receives a public pension from a job not covered by Social Security. Congress enacted the WEP ostensibly to remove an advantage for short-term, higher-paid workers under the original Social Security formula. Yet, instead of protecting low-earning retirees, the WEP has unfairly impacted lower-paid retirees such as educators.

The WEP penalizes individuals who move into teaching from private-sector employment, or who seek to supplement their often insufficient public wages by working part-time or in the summer months in jobs covered by Social Security. Educators enter the profession often at considerable financial sacrifice because of their commitment to our nation's children and their belief in the importance of ensuring every child the opportunity to excel. Yet, many of these dedicated individuals are unaware that their choice to educate America's children comes at a price—the loss of benefits they earned in other jobs.

While the amount of reduction depends on when the person retires and how many years of earnings he or she has accumulated, many public employees can lose a significant portion of the Social Security benefits they earned in other jobs. Like the GPO, the WEP can have a devastating impact on educators' retirement security. For example:

From NEA member Carolyn in Kentucky:

*"I started a direct sales business from my home at nights and weekends to supplement my teacher retirement. I earned my necessary quarters, reached my 62nd birthday, and then learned of the Windfall Elimination Provision. I was told that I was eligible to receive approximately \$158 monthly; however, because of the WEP, this would be reduced to \$78 a month. By the age of 65, my payments had risen to \$84, but after paying \$66 for Part B of Medicare, I now have \$18 to deposit. I have been forced because of the economics of the day to return to the classroom to substitute teach for a paltry sum of \$61 a day. . . . This is certainly not the American dream I had in 1956 to become a teacher!"*

### **The "Double Whammy": Educators Impacted by Both the GPO and WEP**

Many NEA members report that they are subject to double penalties—losing both their own benefits and spousal benefits due to the combined impact of the GPO and WEP. For example NEA member Martha from Texas reports:

*"By 1978, when I started my teaching career, I had already earned my 40 quarters of Social Security and over the years depended on these benefits as part of my retirement. I should be entitled to \$415 a month at the age of 62. However, because of the Windfall Elimination Provision, I will now be entitled to \$206 a month, and this reduction in my earned retirement is a big loss. [In addition], according to the Social Security Administration, I should be entitled to approximately \$970 a month for widow's benefits. However, because of the Government Pension Offset, I can only receive \$21 a month. Both the Government Pension Offset and Windfall Elimination Provision are devastating to teacher retirees and me."*

### **The National Impact of the GPO and WEP: Undermining Teacher Recruitment Efforts**

The GPO and WEP have an impact far beyond those states in which public employees like educators are not covered by Social Security. Because people move from state to state, there are affected individuals everywhere. The number of people impacted across the country is growing every day as more and more people reach retirement age.

Perhaps most alarming, the GPO and WEP are impacting the recruitment of quality teachers to meet urgent national shortages. Record enrollments in public schools and the projected retirements of thousands of veteran teachers are driving an urgent need for teacher recruitment. Estimates for the number of new teachers needed range from 2.2 million to 2.7 million by 2009.

At the same time that policymakers are encouraging experienced people to change careers and enter the teaching profession, individuals who have worked in other careers are less likely to want to become teachers if doing so will mean a loss of Social Security benefits they have earned. Some states seeking to entice retired teachers to return to the classroom have found them reluctant to return to teaching because of the impact of the GPO and WEP. In addition, current teachers are increasingly likely to leave the profession to reduce the penalty they will incur upon retirement, and students are likely to choose other courses of study and avoid the teaching profession.

The GPO and WEP also impact other critical public services fields, including police and firefighters. Our nation can ill-afford to allow the very real fear of poverty in retirement to force talented, dedicated individuals out of these professions.

#### **The GPO/WEP Solution: Total Repeal**

Representatives McKeon (R-CA) and Berman (D-CA) have introduced the Social Security Fairness Act of 2005 (H.R.147). This bipartisan legislation, which already has over 260 cosponsors, would eliminate the GPO and WEP, thereby allowing public employees, like all other employees, to collect the benefits they earned and need. NEA urges the Subcommittee, and the entire House of Representatives, to take immediate steps toward passage of the McKeon-Berman Bill.

#### **Mandatory Coverage: An Unwise and Unnecessary Approach**

NEA's position on repeal of the Government Pension Offset and Windfall Elimination Provision should not in any way be interpreted as support for requiring public employees to participate in Social Security. NEA strongly opposes mandatory coverage. Instead, NEA simply believes that educators should be able to receive the benefits they or their spouse earned by working in covered employment, without jeopardizing their public pension.

Many existing public employee programs are tailored to meet the needs of specific employee groups. Forcing educators into Social Security would jeopardize these state and local plans. In addition, Social Security trust funds can be invested only in U.S. Treasury bonds. State and local governments permit a greater diversity of investment options, thereby potentially achieving a greater rate of return.

Mandatory coverage of educators would also increase the tax burden on public-sector employers. Ultimately, these increased tax obligations would lead to difficult choices, including reducing the number of new hires, limiting employee wage increases, reducing cost-of-living increases for retirees, and reducing other benefits such as health care.

Finally, mandating coverage of educators will not solve the Social Security system's financial difficulties. The amount of money gained by mandating coverage would be relatively small and would not solve the long-term Social Security crisis. Requiring new state and local employees to pay into Social Security would enable the federal government to continue borrowing money from Social Security trust funds, and, therefore, could exacerbate financing problems.

We thank you for your consideration of these comments.

---

#### **Statement of Olivia S. Mitchell<sup>1</sup>, Wharton School, University of Pennsylvania, Philadelphia, Pennsylvania**

Mr. Chairman and members of the Subcommittee: Thank you for the opportunity to appear here today. My name is Olivia S. Mitchell, and I am a Professor of Insurance and Risk Management at The Wharton School at the University of Pennsylvania.

As you know, Social Security faces imminent insolvency, with payroll tax revenues threatening to fall below benefit payments within 6 years. The present system also contains many inequities and anomalous redistribution patterns, and it offers current workers a surprisingly low and very risky return.<sup>2</sup>

The bipartisan Commission to Strengthen Social Security (CSSS), on which I served in 2001, believed that offering *two separate tiers* under a reformed Social Security program, each with its own function, would improve the overall program's transparency and equity. Social adequacy was to be the principal objective of the traditional defined benefit piece, while individual equity was seen as the goal of a personal accounts component.

My testimony before this Subcommittee today focuses on two aspects that must be evaluated in designing a Personal Retirement Account element as part of a reformed Social Security: (1) administrative fees and charges, and (2) payout issues. My views derive from the research literature on administrative fees and payout issues, particularly regarding how Personal Retirement Accounts might be invested and how

---

<sup>1</sup> Olivia S. Mitchell is the International Foundation of Employee Benefit Plans Professor and Professor of Insurance and Risk Management; she is also Executive Director, Pension Research Council and Director, Boettner Center for Pensions and Retirement Security, all at The Wharton School of the University of Pennsylvania. The views offered here are solely those of the author and do not represent those of any institutions with which she is affiliated.

<sup>2</sup> Cogan and Mitchell (2002).

the funds at retirement might be deployed. The views I offer are my own and do not represent those of any institutions with which I am affiliated.

My conclusions are that the voluntary Personal Retirement Accounts (PRAs) should be formulated so that:

- They offer participants some investment choice while still being relatively inexpensive;
- They standardize disclosure regarding fees and charges so participants can understand and compare them;
- They require retirees to annuitize part of their retirement assets in their Personal Accounts, so that the combined benefit payments from Social Security will keep them out of poverty.

#### Administrative Fees and Charges

Experience with public and private pension plans the world over indicates wide disparity in reported administrative fees and charges across systems. Several lessons are worth highlighting:

- *Measuring pension expenses requires standardized reporting and disclosure standards.* Pension systems often structure their charges in bewildering ways. For instance, fees can be levied as flat commissions, a percent of contributions, or a percent of the fund's annual yield.<sup>3</sup> Such complexity makes it difficult for plan participants to compare fund performance. A sensible response, adopted by many Latin American pension supervisors, is to require disclosure using a standardized table for reporting charges. This has the effect of increasing the information available to participants and hence, making the market more competitive. A more problematic tactic adopted by the UK, for example, is to set a national fee cap. This may limit competition and reduce participants' focus on holding down costs.
- *Scale is important in keeping costs down.*<sup>4</sup> Larger money managers benefit from scale economies, centralized fund administration, and centralized collection of contributions. For example, in Australia, retail financial service providers charge three times more in pension fees and charges than do institutional managers of corporate pensions. While there is little agreement on the minimum size of a cost-effective pension, managers of large defined contribution plans such as the Federal Thrift Savings Plan which covers civil servants and military employees, my University's retirement plan (TIAA-CREF and Vanguard), and others, charge pension participants annual fees between 0.1–0.4% of assets under management. These fees are well below what savers pay in typical Individual Retirement Accounts.
- *Private retirement systems might seem to be more costly than Social Security, but this is a misleading conclusion as they generally offer more and different services.* Some have suggested that the current U.S. Social Security system is one of the lowest-cost programs around. Nevertheless, Social Security does not provide the wide range of services provided by modern managers of asset-backed retirement accounts. For instance, the government program does not invest in the capital market, it holds no insurance-type reserves even though it offers disability and survivors' insurance, and it takes a very long time—more than a year—to post workers' contributions to their records.<sup>5</sup> By contrast, privately managed fund providers would and can do better by taking advantage of modern technology.

Taking these and other factors into account, I and other Commission members concluded that it would be reasonable to *establish personal accounts along the lines of the Federal Thrift Saving Plan*. Accordingly, and for a few years into the system, a central Governing Board would be charged with collecting contributions, managing records, and selecting private-sector managers who would invest participant assets via a competitive bidding process. This Board could either handle record-keeping and benefit payments itself, or these functions could be outsourced via a competitive process.

We also proposed that *investment choices in the personal accounts would be limited but diverse*. The options suggested include:

- a Government Securities Investment fund (mainly short-term U.S. Treasury securities);
- a Fixed Income Index Investment fund (tracking a U.S. bond market index);

<sup>3</sup>Mitchell (1998).

<sup>4</sup>See Mitchell (1998), Bateman and Mitchell (2004), and Whitehouse (2005).

<sup>5</sup>Mitchell (1998).



- a Common Stock Index Investment fund (tracking the Standard & Poor's 500 Index of large-company stock);
- a Small Capitalization Stock Index Investment fund (tracking the Wilshire 4500 stock index); and
- an International Stock Index Investment fund; and
- a fund that invests in Government Treasury Inflation-Protected Securities.

At some later date, plan participants might be permitted to move their investments to licensed, supervised, private money managers offering an approved set of low-cost investment options. The benefit levels that might be expected from alternative investment approaches for Personal Retirement Accounts appear in Table 1, along with a comparison of current benefits, payable benefits, and scheduled benefits.

The Office of the Chief Actuary at Social Security estimated that the proposed CSSS approach *would be quite inexpensive, costing only about 0.3% of assets annually*.

**Table 1: Monthly Social Security Benefits Under Alternative Scenarios Projected to 2052**  
(CSSS Model 2 \$01)

<b>I. Lifetime low-wage earner*</b>	
<i>Today's benefit</i>	\$637
Projected Benefit With Personal Account:	
Low yield	867
Medium yield	1,050
High yield	1,090
Current Program Payable	713
Scheduled benefit	986
<b>II. Lifetime medium-wage earner*</b>	
<i>Today's benefit</i>	\$1,052
Projected Benefit With Personal Account:	
Low yield	1,204
Medium yield	1,525
High yield	1,595
Current Program Payable	1,179
Scheduled benefit	1,628
<b>III. Lifetime maximum-wage earner*</b>	
<i>Today's benefit</i>	1,366
Projected Benefit With Personal Account:	
Low yield	1,565
Medium yield	1,907
High yield	1,983
Current Program Payable	1,557
Scheduled benefit under current law	2,151

\*These categories, developed by Social Security actuaries, are specified (in \$01) such that a lifetime "low" earner would have averaged approximately \$15,900 per year, whereas the medium earner averaged \$35,300 per annum and the high earner \$56,400.

Source: Cogan and Mitchell (2003)

### Payout Issues

When considering how to structure payouts from voluntary Personal Accounts under a reformed Social Security system, naturally the question arises as to whether and how access to the funds should be permitted. CSSS members agreed that *pre-retirement* access to the money should not be allowed to 'leak' out before retirement, as early consumption would likely increase the chances that the elderly would then have to rely on old-age antipoverty programs. Yet, as the Commission pointed out, "a clear appeal of personal retirement accounts is that they grant workers ownership over their own assets." After weighing competing arguments, *we concluded that personal accounts should be preserved until the nationally-agreed on early retirement age*, consistent with current Social Security policy which does not permit pre-retirement access to old-age benefits.

By contrast there is more discussion regarding appropriate designs for the pension *decumulation* process under Personal Accounts. This refers to the process by which older participants access their retirement assets, how they invest their money during retirement, and whether annuities—which are financial products designed to cover the risk of retirees outliving their assets—should play a central role. Regarding post-retirement fund management, my Commission recommended several meth-

ods of drawdown including phased withdrawals and annuities, as well as possibly lump sums.

To highlight the importance of longevity risk, Table 2 shows that a 65-year old U.S. male can anticipate living to age 81, but he has almost a 20% chance of living to age 90 or beyond. A woman of the same age can expect to live to 85, but she has more than a 30% chance of living to age 90 or older (Table 2). In other words, people face substantial risk of outliving their life expectancy, implying substantial uncertainty regarding how long one must conserve and spend retirement assets, combined with a high probability of running out of money.

**Table 2: Remaining Life Expectancy and Survival at Age 65 (in 2000)**

	Remaining Life	Men	Women
Expectancy (years):		16.4	19.6
Probability of Surviving to Age:			
70		88%	92%
75		74	82
80		56	69
85		36	51
90		18	31
95		6	14
100		1	4

Source: Mitchell and McCarthy (2004)

A life-long annuity can help protect against this risk, by paying a premium to an insurer who then pools a number of people with similar longevity expectations. Though some have argued that such insured products seem expensive, my research shows that the “money’s worth” (MW) of such life income products is rather substantial. The MW refers to the discounted cash flow of the lifetime payments received divided by the product premium. For example, Table 3 shows that U.S. purchasers of an immediate single-life annuity would expect back 93 cents on the dollar from a life annuity; in exchange purchasers have the insurance value that they will never outlive their lifetime benefit payments. The MW ratios are similar in Australia, Italy, and the UK.

**Table 3. Money's Worth of Single Premium Nominal Life Annuities for 65-Year Olds: An International Comparison** (using country Treasury yield curves and annuitant life tables)

	Australia	Canada	Italy	UK	US
Men	0.986	1.014	0.958	0.966	0.927
Women	0.970	1.015	0.965	0.957	0.927

Source: Derived from Mitchell and McCarthy (2004)

These issues are complex and potentially politically delicate, since some workers will fail to accumulate much in their accounts over their worklives; also some retirees might anticipate relatively lower-than-average life expectancies, making forced annuitization seem punitive.

In balancing the various choices for payout design, the Commission concluded that *partial annuitization should be mandated* so that “the yearly income received from an individual’s Social Security benefit plus the joint annuity (if married) would protect either spouse from falling below the poverty line during retirement” (CSSS 2001). Any funds above those needed to buy the minimum annuity could be accessible as a lump sum and/or bequeathed at death. This approach has the dual benefit of both protecting the retiree from falling below the poverty line while still allowing some access to the funds accumulated in the Personal Retirement Account.

Remaining design issues include how retirees would learn about annuity products, who would sell them, and whether the private insurance market can do a good job meeting market demand. To date, relatively few consumers have purchased payout annuities, making it a bit difficult to forecast how the market will develop. Several key issues will have to be decided:

- *Which annuity products will be offered and to whom?*

Currently private insurers in the U.S. offer a wide and very complex array of annuity products, including immediate versus deferred benefit payments; fixed nominal payouts versus programs with escalating or variable payouts; and term certain

versus other payment periods. Also annuities offered through company pensions are mandated to use unisex mortality tables whereas retail annuities do not.

A logical lesson from the behavioral finance literature is that it would be sensible to establish a “default” payout format such as a joint and survivor inflation-linked or escalating life annuity, which retirees would automatically receive unless they specifically opted for something else. As a case in point, retirees in the UK are required to annuitize their pension assets at age 75; in Germany, workers with assets in so-called Reister-pensions may take 20% of their accumulated assets in a lump sum, another 20% in a phased withdrawal format; but at age 85, the retiree must annuitize his balance and the benefit may not be lower than the periodic payment received before that age.

Of course, since many retirees are not accustomed to thinking about longevity risk, they would require financial education to help them clearly understand the costs and benefits of different ways to manage their Personal Retirement Account assets.

- Which annuity providers will be allowed in the market, and how will they be regulated?

Evidence from other countries adopting personal accounts indicates that private insurers can and do offer the types of products that retirees want. For instance, in Chile, middle and upper income workers generally prefer the annuity payout over a phased withdrawal approach to retirement drawdowns.

Nevertheless, there will likely have to be some governmental oversight over the annuity market. In Mexico, for instance, all insurers are required to bid on all retirees, and when issuing annuity bids, the companies may learn only a retiring worker's age and sex (but not his identity, his health status, or his account balance). This reduces the chances of “cherry-picking” rich retirees or those anticipated to die soon.

Another issue has to do with whether unisex mortality tables would be required for the annuities. Doing so, of course, involves redistribution of wealth away from shorter-lived men and toward longer-lived women, which is already true in the current Social Security System. Requiring joint and survivor benefits as a default would render this issue less important quantitatively.

- What role, if any, would the federal government have?

As an alternative to building up private annuity markets, some have suggested that the federal government might directly sell the mandatory annuities under the new system.<sup>6</sup> While this might hold down some costs, it can cause other problems. For example, there could be political interference associated with investing the annuity reserves—amounting to 15% of GDP at maturity—and it raises questions about whether the reserves could truly be saved, or whether they would be ‘spent’ akin to Social Security Trust Fund assets. Further, the government would then have responsibility for mortality and capital market risk, which would likely be incorrectly priced and managed.

One key role for the federal government in this context has to do with tax and transfer policy. For instance, pension and Individual Retirement Account assets are protected in bankruptcy but are divisible in divorce; whether the same treatment would be afforded PRA annuities and assets has yet to be determined. Conversely, annuity flows and lump sums are generally ‘counted’ when retirees apply for SSI and Medicaid benefits; payouts are taxed as income. Whether and how PRA assets and annuities are to be treated for tax and transfer purposes—as well as others (e.g. the estate tax vulnerability of the PRA assets if the worker or spouse dies) will take additional work to get it right.

Another role for the government is to enhance the range of investments available to insurers providing the products.<sup>7</sup> Many writers have noted the key role of *federal government provision of inflation-indexed bonds sufficient to meet market demand*. Expanding their supply would allow private insurers to offer the kinds of indexed annuity products that would give retirees better protection against inflation, which is a source of substantial retirement insecurity.

## Conclusion

My testimony has focused on the role of administrative fees and charges in a PRA type approach, and also on payout considerations after retirement. I conclude that voluntary Personal Retirement Accounts can be designed so as to provide participants with some investment choice while still being relatively inexpensive; they can build in incentives for competition among fund managers, including disclosure re-

<sup>6</sup>NASI (2005).

<sup>7</sup>Bodie et al. (2002).

garding fees and charges; and they can sensibly require retirees to annuitize part of their retirement assets in their Personal Accounts, so that the combined benefit payments will keep them out of poverty.

Thank you for your interest and I am happy to answer any questions you may have about my remarks.

### References

Bateman, H. & O.S. Mitchell. "New Evidence on Pension Plan Design and Administrative Expenses." *Journal of Pension Finance and Economics*. 2004: Vol 3(1): 63–76.

Bodie, Z., B. Hammond, and O.S. Mitchell, eds. *Innovations in Financing Retirement*. Philadelphia, PA: University of Pennsylvania Press, 2002.

Brown, J.R., O.S. Mitchell, J.M. Poterba. "The Role of Real Annuities and Indexed Bonds in an Individual Accounts Retirement Program." In *Risk Aspects of Investment-Based Social Security Reform*. Eds. J. Campbell and M. Feldstein. 2000: 321–360.

Brown, J., O.S. Mitchell, J. Poterba, and M. Warshawsky. *The Role of Annuity Markets in Financing Retirement*. MIT Press, 2001.

Commission to Strengthen Social Security (CSSS), *Strengthening Social Security and Creating Personal Wealth for all Americans*, Final Report, Washington, D.C., December 2001.

Cogan, J.F. & O.S. Mitchell. "Perspectives from the President's Commission on Social Security Reform." *Journal of Economic Perspectives*. 17(2). Spring 2003.

Mitchell, O.S. "Administrative Costs of Public and Private Pension Plans". In *Privatizing Social Security*, Ed. M. Feldstein. NBER. Chicago: University of Chicago Press, 1998: 403–456.

Mitchell, Olivia S. & David McCarthy. "Annuities for an Ageing World". In *Developing an Annuities Market in Europe*. Eds. E. Fornero & E. Luciano. Elgar, 2004: 19–68.

NASI *Uncharted Waters: Final Report*. [http://www.nasi.org/info-url\\_nocat2718/info-url\\_nocat\\_show.htm?doc\\_id=212573](http://www.nasi.org/info-url_nocat2718/info-url_nocat_show.htm?doc_id=212573)

Whitehouse, E. *Testimony Before the Subcommittee on Social Security of the House Committee on Ways and Means*, Washington, D.C. June 16, 2005.

---

### Statement of Robin Sewell, Littleton, Massachusetts

I worked to earn 40 quarters and had social security payments taken out of my paycheck for years. As I completed my undergraduate degree and master's degree in my late 20's and 30's, I started another career as an employee for the town of Littleton as a teacher over 17 years ago. Because I began my teaching career later in life, I will have a very difficult time putting in my years of service to even come close to reaching a moderate percentage from my municipal retirement.

And, if my husband should pre-decease me, my widow benefits, even though he paid the maximum for social security each year, will also be severely impacted.

Please consider that the current provisions penalize those "qualified" workers who have a career change or start working for a municipality later in life.

